CHAPTER 2

Literature Review

The purpose of this chapter is to provide a review of relevant literature on accounting conservatism and management earnings forecasts. Section 2.1 discusses accounting literature on the definition and concept of accounting conservatism. In section 2.2, a brief discussion of agency theory is provided. Section 2.3 summarizes the concepts of corporate governance and control on agency problems. In section 2.4, a description of the confirmation hypothesis is presented. Section 2.5 discusses literatures on management earnings forecasts. Section 2.6 discusses empirical studies on accounting conservatism in Thailand. Finally, section 2.7 summarizes the empirical evidence on management earnings forecasts in Thailand.

2.1 Accounting conservatism

2.1.1 Definition of accounting conservatism

The definitions of accounting conservatism have been proposed by accounting standard setters and accounting literature. An often-cited definition of conservatism in accounting is that accountants "anticipate no profit, but anticipate all losses" (Bliss 1924 cited in Watts 2003). Based on this definition, "to anticipate profits" means to record profits before there is legal claim to their associated future cash flows, and before the revenues are verified (Watts 2003). An official definition of accounting conservatism from SFAC No. 2 (Statement of Financial Accounting Concepts No.2 Qualitative Characteristics of Accounting 1980) states that:

> "*Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate; however, if two amounts are not equally likely,*

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one." (Financial Accounting Standards Board 1980, 25)

The AICPA defined accounting conservatism as accounting practices that recognize all losses when they occur and not when they are realized, but do not recognize gains until they are realized and, if in doubt, errs on the side of undervaluing assets and overvaluing liabilities (AICPA Special committee on Financial Reporting 1994)

According to the Accounting Framework (revised 2009), conservatism, currently called prudence, is defined as:

"*Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability*." (Federation of Accounting Professions - Thailand 2009, 13)

The official definition of accounting conservatism is descripted above. In accounting literature, the definition of accounting conservatism takes two main perspectives. The first perspective of conservatism is unconditional conservatism; *ex ante* conservatism or news-independent conservatism. For the second perspective, conservatism is conditional conservatism; *ex post* conservatism or news-dependent conservatism (Beaver and Ryan 2005).

For *ex ante* conservatism, Beaver and Ryan (2005) used the news-independent perspective to define conservatism. According to them, unconditional conservatism is news-independent conservatism that leads firms to report book value of shareholders' equity in which the book values are persistently understated compared to the market value during their lifetime. The news-independent perspective involves predetermined

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

understatement of book value of net assets (Ball and Shivakumar 2005; Ryan 2006). Ball and Shivakumar (2005) concluded that unconditional conservatism does not improve contract efficiency if the magnitude of the bias is known. Contract efficiency, however, may decrease if the magnitude of the bias is unknown.

From a news-dependent perspective, accounting conservatism is defined as a higher standard of verification needed in recognizing gains than for recognizing losses.[4] As Basu's (1997) work noted, conditional conservatism is news dependent, and it causes earnings to reflect bad news in a timelier manner than good news. According to Basu (1997, 4), conservatism is "the accountant's tendency to require a higher degree of verification for recognizing good news than bad news in the financial statement." Watts (2003) stated that conservatism is a differential verification requirement for gains and losses. Therefore, it can be said that the degree of conservative reporting can be measured based on the degree of verification required for gains compared to that required for losses. Taking the same news-dependent perspective, Givoly and Hayn (2000) defined conservatism as a selection criterion among accounting principles that results in the minimization of cumulative reported earnings.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Literature points out the interdependence of these two perspectives in that the higher verification needed for recognizing gains than for recognizing losses will always lead to a persistent understatement of book value and, for growth firms this will result in a downward bias in cumulative earnings (Roychowdhury and Watts 2007). Of the two perspectives, accounting literature insists that conditional conservatism is the only one that provides information regarding the future operations of firms (Basu 1997; Ball, Kothari, and Nikolaev 2013). In addition, it was found to have an important information

[4] This definition encompasses a broad set of accounting policies, including both accounting methods and estimates. Examples of conservative accounting methods are accelerated depreciation, lower of cost or market for inventories, and expensing research and development, and adverting investments. Examples of conservative accounting estimates include overestimates of expenses (e.g. bad debt allowances), losses (e.g. contingent losses), and liabilities (e.g. pension liabilities) and underestimates of revenue (e.g. deferred revenue), gains (e.g. contingent gains), or assets (e.g. assets impairment).

role in increasing contract efficiency (Ball, Kothari, and Robin 2000; Ball and Shivakumar 2005).

This study based its hypotheses and measures on the news-dependent conservatism perspective and operational definition. In this study, the term “conservatism” is used to refer to “conditional conservatism” in accounting. Thus, conservatism is referred to as the more timely recognition of losses as compared to the recognition of gains. The differences in recognition timeliness are in the costs and benefits resulting from asymmetric verified information reported by managers and/or firms. In addition, the requirements of conservatism regarding asymmetric verification includes timely loss recognition and the postponement of recognizing good news until profits are verified.

2.1.2 The demand for accounting conservatism

The demand for accounting conservatism in financial statements arises from many sources. Watts (2003) summarized four distinct demands for conservative reporting: to address moral hazard problems between various contracting parties having asymmetric payoffs, limited liabilities, or differing horizons; to minimize shareholder litigation; to lower tax payments (as reported GAAP income is correlated with earnings reported for tax purposes); and to appease regulators' asymmetric costs related to overstated versus understated earnings.

The first explanation of demand for conservatism is the contracting explanation. The contracting explanation is conceptualized based on the agency theory (Watts 2003). Conservative accounting approach is used as an efficient report mechanism employed in firm governance and is used to deal with the moral hazard determined by asymmetric information, limited liability, and asymmetric payoffs of the different parties involved in the firms. Therefore, management compensation contracting is a reason for the start of both accounting and conservatism, and that conservatism constrains managerial opportunistic behavior and offsets managerial biases with its asymmetrical verifiability requirements (Watts 2003).

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

The second explanation of accounting conservatism is limited shareholder litigation. The asymmetric payoff is that the overstatement of a firm's net assets is more likely to increase the litigation costs for the firm than the understatement of net assets (LaFond and Watts 2008). Despite the fact that asymmetry in litigation costs is alight, shareholder litigation should be limited to and constrain the opportunistic behaviors of managers and other parties in the firm. However, under accounting conservatism, the firm reduces its expected litigation costs to avoid shareholders' litigation risk.

The third explanation is taxation which links to the conservatism in financial reporting. Asymmetric recognition of gains and losses enables managers of profitable firms to reduce the present value of taxes, therefore increasing value of the firm by accelerating expense recognition and deferring revenue recognition (Watts 2003).

Standard setters and regulators are the fourth explanation of conservatism in financial reporting (Watts 2003). Both standard setters and regulators have the incentives to favor conservative accounting and reporting. They are exposed to asymmetric loss functions because they face more criticisms if firms adopt accounting standards that favor the overstatement of net assets instead of understatement of net assets. For this situation, there is an asymmetry in political costs (referred to as regulators' costs). Thus, conservative accounting and reporting mitigate these costs while the other non-contracting parties (such as voters) also value conservatism's constraints on opportunistic payments to managers and other parties.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Based on the distinct explanations of conservative reporting discussed above, Basu (2005) and Qiang (2007) contended that the demands for conditional conservatism is due to only the contracting and litigation explanations for conservatism. They also argue that unconditional conservatism is related to litigation, tax, and regulatory demands for conservatism. Various studies have explored these explanations for conservatism empirically (see Watts (2003) and Ryan (2006) for comprehensive listings). LaFond and Watts (2008) further asserted that conditional conservatism reduces information asymmetry between managers and market participants. They argued that the equity market's contractual demand for conditional conservatism is distinct from the other explanations of conservatism listed above. Thus, the commonalities of explanations for

conservatism in financial reporting are the asymmetric loss functions of different parties with stakes in the firm and the parties' asymmetric information sets concerning the value of the firm (Watts 2003; Ball and Shivakumar 2005; LaFond and Watts 2008).

Additionally, recent research suggested that conservatism can serve as a corporate governance mechanism to mitigate the information asymmetry among the various parties (such as shareholders, managers, investors, and stakeholders) involved in firms' contracting, shareholder litigation, taxation, and regulation processes. Information asymmetry can arise from the firm's investment opportunity set, information about events and investment opportunities, and report information to stakeholders. In particular, Watts (2003, 2006) described conservatism as part of the efficient technology employed in the organization of the firm and its contracts with various parties. However, the empirical evidences on whether firms with high agency cost problems are positively associated with accounting conservatism are still mixed (Armstrong, Guay, and Weber 2010).

While all of these explanations suggest that conservative reporting benefits users of financial statements, the contracting explanation (i.e., compensation contract and debt contract) has been the most extensively developed and is considered to be the most important factor in explaining demand for conservative reporting (Watts 2006). Watts (2003) suggested that conservatism helps address moral hazards caused by contractual parties to firms that have asymmetric information, asymmetry payoffs, limited horizons and limited liabilities. Contractual parties to the firm (e.g., shareholders and creditors) face agency conflicts such as substitution and underinvestment. Conservative reporting has been hypothesized to increase the efficiency of debt contracts by mitigating these agency problems. Creditors or lenders benefit from conservative reporting *ex post* through a more timely signal of default risk in the form of accelerated covenant violations by more conservative borrower firms (Zhang 2008; Armstrong, Guay, and Weber 2010). Timely loss recognition provides creditors with new information so that they can make decisions and react to financial contract violations and enforce their contractual rights, such as restricting the leverage ratio, investment and dividend policy, in a timely fashion.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

In debt contracting, conservative reporting reduces agency conflicts between shareholders and lenders (Ahmed et al. 2002).[5] Because lenders and borrowers contract on the financial reports through financial covenants, conservative reports enable lenders to receive a more timely signal of deteriorating financial performance through a tightening of covenants or a triggering of covenants violations sooner than less conservative firms. The timely signal of deteriorating financial performance allows lenders to take proactive action, thereby reducing their downside risks and may lead to debt restructuring. Zhang (2008) documented that lenders receive a timely signal of default risk and then the borrowers obtain a lower interest rate from conservative reporting.

In summary, accounting conservatism arises to reduce information asymmetry and mitigate agency conflicts between managers and their firms' shareholders and creditors (Ball, Kothari, and Robin 2000; Ahmed et al. 2002). Specifically, conservatism plays an important role in facilitating management compensation and debt contracting processes, i.e., either by designing a contract or monitoring a contract (Watts 2003; Zhang 2008; Armstrong, Guay, and Weber 2010). Prior accounting literature pay close attention to the information role of conservatism in debt contracts and provide extensive evidence on the demands for conservatism in financial reports. However, there is limited studies examining the consequences of conservatism and its information role in capital market.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่

2.1.3 Consequences of accounting conservatism

Copyright© by Chiang Mai University
All rights reserved

Accounting conservatism, specifically conditional conservatism, is useful in improving contracting efficiency, i.e., management compensation contracts, debt contracts, and shareholder contracts (Ball, Kothari, and Robin 2000; Ball and Shivakumar 2005). In addition, conditional conservatism contains information on the company's future operations (Basu 1997).

[5] Ahmed et al. (2002) were the first to document that conservatism reduces costs of debt for borrowers, i.e., more conservative borrowers receive better debt ratings (proxy for the cost of debt).

Based on the contracting explanation, there are two important roles of conservative reporting that help improve efficient contracts. The first role of conservative reporting is that it imparts a downward bias in reported net worth so as to offset management's self-serving motivations of biasing net worth upwards. The second role is that conservative reporting commits managers to recognizing bad news in a more timely manner than good news so as to mitigate moral hazard and information asymmetry (Basu 1997; Watts 2003; Ball and Shivakumar 2005; Armstrong, Guay, and Weber 2010). Since contracting parties (i.e., creditors, suppliers, customers, and employees) are expected to contract around an accounting bias towards reporting lower bound earnings and book values of shareholders equity (Hui, Klasa, and Yeung 2012), conservatism is more likely to improve contracting efficiency through reductions in agency conflicts between managers and creditors, and shareholders and creditors (Basu 1997; Watts 2003; Ball and Shivakumar 2005; Zhang 2008). As such, conservative accounting is suggested to decrease information asymmetry and agency conflicts between managers and outside investors.

In the context of conservatism's influence on manager-shareholder contracts, it was found that conservatism plays a part in the reduction of asymmetry in information (LaFond and Watts 2008). In addition, Hui, Matsunaga, and Morse's (2009) study showed a significantly negative relationship between conservatism and management forecast frequency, specificity and time horizon. Based on the results, Hui, Matsunaga, and Morse suggested that firms can utilize conservatism and management earnings forecasts as a means of reducing the gap of information between managers and investors.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Concerning the link between conservatism and firm value, Feltham and Ohlson (1995) suggested that accounting conservatism holds a significant influence on firm valuation due to its nature as an unrecorded goodwill in the operating assets records. Compared to unbiased accounting, which completely capitalizes initial investment, conservative accounting takes less (partial) capitalization. It was therefore expected that the bias in operating assets recognition would have an impact on the positive relationship between conservatism and the valuation multiple on operating assets. In addition, Feltham and Ohlson (1995) made a prediction about the incremental dollar earnings when

conservative accounting is used. Specifically, it was expected that if the accounting system is conservative, the incremental dollar of cash earnings would be worth less than the increment of non-cash earnings. The expectations were based on the low earnings yielded by conservative accounting during early periods and higher earnings in later periods. Ahmed, Morton, and Schaefer's (2000) study supported Feltham and Ohlson's (1995) when accounting conservatism measures were found to be positively related to the valuation multiple on operating assets. In addition, it was reported that conservatism measures are an important factor in the valuation model used to incrementally explain firm valuations. Similarly, Mason (2004) reported the positive relationship between accounting conservatism and the valuation multiple on operating accruals.

Another supporting evidence was by Penman and Zhang (2002), who studied the interactive role of accounting conservatism and investment growth in determining future returns. According to their hypothesis, conservative accounting would result in the decrease of current earnings and increase in reserves in the case of investment growth. On the other hand, when a reduction in investments occurs, reserves are recognized into earnings which would result in higher future returns. Results from their test supported the hypothesis that, together, conservative accounting and investment growth decrease the predictability of earnings, leading to the reduction in earnings quality. Monahan (2005) found that conservative accounting policies involving research and development (R&D) expenses have an impact on earnings returns. However, the effect was only found in firms with high R&D growth.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

In a more recent study, Watts and Zuo (2011) found that U.S. firms with more conservative reporting experienced less negative stock returns compared to less conservative reporting during the 2008 global financial crisis. In addition, a positive association between accounting conservatism and the crisis period stock returns was found to be more pronounced when there were greater ex-ante agency costs. These are explained by conservative firms' issuance of more debt and increased investments during the crisis period. This finding is consistent with that of LaFond and Watts (2008) which explained that the role of conservatism in constraining managerial opportunism becomes

more important when greater agency costs and information asymmetry problems are involved.

2.2 Agency theory, conservatism and management forecast

The agency theory explains that the firm plays a role of being the center that connects resource holders (stakeholders). A firm comprises of several parties that are connected with each other through contracts. As a result, the firm is referred to as a "nexus of contracts." These parties, including the firm's shareholders, managers and debtholders come together with different, and sometimes conflicting, interests (Jensen and Meckling 1976). Jensen and Meckling (1976) defined agency relationship as a contract under which one or more persons (principal) engage with another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to that person. The purpose of this contract is to mitigate potential agency problems that can arise from separating control function from ownership inside the firm.

When conflicts of interest arise between the firm's management and its capital providers (i.e., shareholders and lenders), it is referred to as an agency problem (Jensen and Meckling 1976). There are currently a large number of research conducted to understand the nature of agency problems and the consequences of these manager-shareholder conflicts, and the resolutions to these problems.

The agency theory is concerned with agency problems that arise from conflicting interests among a firm's contracting parties when they receive information that are inconsistent (information asymmetry) or when there are uncertainties in the absence of information. The agency theory, which is based on the key concepts of asymmetric information and incentive creation (moral hazard), has the main purpose of explaining how parties minimize costs resulting from agency problems through the way contracts are designed.

An agency relationship is said to exist when a person's actions affect his or her interests, as well as the interests of the person with whom he or she is in an explicit or implicit contractual relationship with. This relationship comprises of the agent (person who undertakes action) and the principal (person affected by the agent's actions). In this

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

case, the interest (utility or welfare) of the principal is measured in monetary value. A common agency relationship is one between the firm's stockholders (principals) and the firm's managers (agents) (Jensen and Meckling 1976; Eisenhardt 1989; Walsh and Seward 1990).

It is natural for the principal to expect the agent to take the principal's interests as the main priority. However, more often than not does the agent act upon his or her own interests before the principal's interests:

> *"We define an agency relationship as a contract under which one or more persons (the principal(s)) engage(s) another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties of the relationships are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal"* (Jensen and Meckling 1976, 5).

In this case, the principal would want to design a contract that serves as an incentive for the agent to act upon the benefits of the principal and maximizes the principal's welfare. The problem, however, lies in the amount of asymmetric information that exists between the principal and the agent, with the latter party possessing information not available to the former. These information inconsistencies poses a challenge for the principal when observing the agent's behavior.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Information asymmetry between the principal and the agent leads to difficulties in designing the contract and, consequently, a moral hazard problem. A moral hazard problem is caused by the principal's inability to keep track of his or her agent's actions due to the amount of costs the principal would have to incur in order to do so. In addition, it is unlikely that a perfect contract that details the agent's every action could be made due to the costs it would entail to write and implement (Kotowitz 1987; Brennan 1995).

> *"Moral hazard may be defined as actions of economic agents in maximizing their own utilities to the detriment of others, in situations where they do not bear the full consequences or, equivalently, do not*

> *enjoy the full benefits of their actions due to uncertainty and incomplete or restricted contracts which prevent the assignment of full damages (benefits) to the agent responsible"* (Kotowitz 1987, 549).

This loophole opens up the opportunity for the agent to act in ways that may negatively affect the principal's utility. In other words, the agent may choose to do things that conflicts with the principal's benefits.

In contemporary financial and accounting theories, the agency theory is commonly used to explain the actions and decision-making behaviors of managers. The agency theory is applicable to the current business environment where a firm's owners and stakeholders can observe the actions and behaviors of the agent (manager) (Zingales 2000).

The agency-based theory can be used to explain factors managers take into consideration when deciding the accounting methods the firm should implement. The original development of accounting and financial reporting appears to be driven by the control of agency costs (Watts 2006). As public companies prepare financial statements for contracting purposes, e.g., contract with investors, lenders, and managers, audited financial reporting is a corporate governance mechanism (Watts 2006). Conservative accounting is an accounting principle and policy that helps in the alignment of managerial decisions and firm objectives (Watts 2003). In addition, voluntary management earnings forecasts is a mechanism employed to decrease asymmetric information between corporate managers and equity investors. Therefore, the agency theory served as the basis in developing the research hypotheses in this study.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

2.3 Corporate governance

Despite the conflict of interests faced by principals (i.e., shareholders) as mentioned in the agency theory, it is common practice for equity investors who own the firm's capital to give the firm's manager the authority to act on one's behalf. This ongoing practice is largely explained by the development of corporate governance.

Corporate governance is an institutional mechanism utilized by today's firms in monitoring and contracting activities (Shleifer and Vishny 1997). According to the

American Management Association, "corporate governance is about how suppliers of capital get managers to return profits, make sure managers do not misuse the capital by investing in bad projects, and how shareholders and creditors monitor managers." In other words, corporate governance looks into the means that equity investors use to assure that they get returns from their investments (Iskander et al. 1999; Shleifer and Vishny 1997).

One of the roles of corporate governance is to monitor the manager's actions in the firm. This monitoring role assists and protects external investors through mechanisms such as the formation of a strong board of directors, the utilization of internal control mechanisms and the use of an external audit. Another mechanism under corporate governance is the use of a compensation system that serves as an incentive for the manager to decide and act toward the benefit of the firm's investors (Murphy 1999; Watts and Zimmerman 1986).

Corporate governance is a system that constitutes of both institutional and market mechanisms aimed at protecting shareholder benefits (Denis 2001). These mechanisms are used to reduce or control agency problems, as mentioned earlier. Jensen (1993) identifies four categories of control mechanisms, including capital markets, legal and regulatory system, product and factor markets, and internal control system headed by the board of directors.

The separation made between a firm's owners and its managers highlights the essential roles of managers in the performance of today's firms. As a result, agency problems concerning monitoring and managerial motivations emerge. In this case, the board of directors has a major influence on the firm's performance as they take on the governance role which affects the effectiveness of the firm's internal control system, such as in mitigating agency problems. The internal control mechanism, which includes the size and composition of the board of directors, plays an important part in determining the effectiveness of the firm's corporate governance (Denis 2001). Studies relating to voluntary disclosure and earnings management concluded that board composition enhances the quality of accounting information (Anderson, Mansi, and Reeb 2004; Ajinkya, Bhojraj, and Sengupta 1999; Armstrong, Guay, and Weber 2010).

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Theoretically, members of the board are directly elected by the firm's shareholders. In order to maintain their position in the firm, the board is expected to make decisions that maximize shareholders' wealth (McColgan 2001). Fama and Jensen (1983) suggested that recruiting outside directors and recognizing the chief executive officer (CEO) and board chairperson as two distinct positions can help the firm gain effectiveness. This requires the board of directors to take the role of a market solution to contract problems, or agency problems, within the firm (Hermalin and Weisbach 1991). To gain effectiveness, responsibilities within the firm should be clearly separated. Specifically, managerial functions should be assigned to management while control functions should be the responsibility of the board of directors. The majority of prior studies found that outside directors and the separation of the CEO and board chairperson into two separate positions have a positive influence on the firm's board of directors as a control mechanism (Delton et al. 1998).[6]

Aside from outside directors and the separation between the positions of CEO and board chairperson, the size of the board of directors is believed to be another contributor to the board's effectiveness. The difference between large and small boards of directors lies in the speed and efficiency in communicating and making decisions. Boards with few members allow for faster communication and coordination (Jensen 1993) and less problems with free-riders (Hermalin and Weisbach 2003). On the other hand, more members in the board lead to slower and less efficient decision-making due to the hesitation of members to be straightforward when differences in opinions exist and the amount of time needed to gain consensus on an issue (Jensen 1993). The advantage of large boards of directors, however, is their tendency to include directors who possess more experience, enabling them to focus on their assigned responsibilities (Xie, Davidson, and DaDalt 2003). Despite the inconclusive findings concerning the relationship between board size and firm performance, large boards of directors were found to play a role in reducing agency problems (Gales and Kesner 1994).

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

[6] In literature, the separation between the positions of CEO and board chairperson is called "CEO non duality."

In addition, institutional investors are also important in a firm's monitoring activities. Individual shareholders may lack the time, the knowledge or the willingness to monitor the activities of managers as they tend to own only a small portion of the firm's total shares. Therefore, some shareholders do not see the importance of monitoring managerial activities and decide to get a free ride. The free-rider problem refers to the situation in which shareholders do not see that monitoring activities works in their best interests since there are others who could also benefit from the activity. This problem can be solved by institutional investors or blockholders. This group possesses the needed skills, have more time, and have the financial incentives to monitor managers, thus solving the free-rider problem. It is also possible for institutional investors or blockholders to elect themselves into the firm's board of directors, enabling them to monitor managerial activities even more closely. CEOs may want to reduce monitoring costs and choose to disclose important firm-related information to institutional investors (Ajinkya, Bhojraj, and Sengupta 1999, 2005).

In sum, agency theory and corporate governance are designed to cope with the costs and problems resulting from principal-agency conflicts. The extent of conflict between principal and agent, and the effectiveness of the mechanism used to alleviate the problem are found to differ according to firm, industry, company culture, and institutional settings.

2.4 Confirmation and substitute hypotheses

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Accounting literature suggest explanations to understand the connection between audited financial reporting and voluntary financial information disclosure by proposing two competing hypotheses: the confirmation hypothesis and the substitute hypothesis (Ball 2001; Ball, Jayaraman, and Shivakumar 2012). The underlying concept in developing the hypotheses stems from the role of financial reporting in the corporate information environment. The roles of financial reporting are composed of contracting and informational roles (Watts and Zimmerman 1986).

In terms of the confirmation hypothesis, Ball, Jayaraman, and Shivakumar (2012) descripted that audited financial reports serve as one of the inputs in the firm's

overall information environment. The usefulness of the financial report is designed and assessed based on how much it contributes to the effectiveness of the entire information environment in communicating reliable accounting information with investors and relevant parties.

According to the confirmation hypothesis, financial statements and voluntary disclosure information have complementary roles in improving the overall information environment of the firm (Ball 2001; Ball, Jayaraman, and Shivakumar 2012). These two sources both provide important information but possess different attributes (Ball, Jayaraman, and Shivakumar 2012; Watts 2006). Accounting information contained in financial statements (also referred to as verified information) are taken from past economic transactions. Because financial reports contain actual outcomes, they are considered to be less related to the firm's stock prices and reflect backward-looking outcomes but are, however, verified. On the other hand, public voluntary disclosure is more future-oriented and therefore involves future expectation information. While they are timelier than financial statements, public voluntary disclosure information are not verified on its own or, if verified, would be costly to do so.

When considered in isolation, financial statements have the main role of providing audited financial outcome variables used in contracting with the firm. In addition, they serve as a channel for managers to disclose reliable inside information to users. On the other hand, voluntary disclosure contains firm-specific information that are disclosed solely by managers, and therefore possess an informational role (or economic, value-relevant role) rather than a contracting one.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Reports on *ex post* audited financial outcomes (such as revenue, earnings and book value of assets) allow for outsiders (such as investors, boards, analysts and lenders) to make better decisions based on a comparison of different sources of voluntary disclosures with the eventually realized numbers (Watts 2006; Ball, Jayaraman, and Shivakumar 2012). The financial outcome can also be used to evaluate the truthfulness of past management disclosure information (Ball, Jayaraman, and Shivakumar 2012). The system of having verified accounting information (hard information) available for the

public requires managers to be more honest with their voluntary disclosures (soft information) and consequently, provide more accurate information for relevant parties.

Based on the confirmation hypothesis, information obtained from verified financial statements can be used as a point of reference in evaluating the credibility of competing unverified alternative sources, such as management forecasts and other voluntary disclosures of nonfinancial information. Several accounting literature provided empirical evidence and analytical results that supported the confirmation hypothesis (Gigler and Hemmer 1998, 2001; Stocken 2000; Lundholm 2003). Gietzmann and Trombetta (2003) stated that both mandatory accounting reports and voluntary disclosures have important effects on decisions made by equity investors and, consequently, the firm's cost of capital. However, studying the two reporting practices separately will not produce significant economic implications for disclosure literature (Artiach and Clarkson 2011).

A competing view is the substitute hypothesis, which proposes that audited financial reporting (i.e., earnings information) and managements' inside information can serve as substitutes in improving the corporate information environment (Verrecchia 1983; Diamond 1985). In particular situations, firms with superior quality in accounting information stated in financial reports tend to have less motivation of voluntarily announcing details about their information. In early theoretical concept, Verrecchia (1983) reasoned that these firms have non-zero costs of going public with the firm-specific information. However, disclosure literature argues that voluntary information disclosed by managers are perceived as not trustworthy and possess less value relevance which do not associate with firms' stock prices (Crawford and Sobel 1982; Healy and Palepu 2001).

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

In conclusion, the relationship between information quality and voluntary disclosure decisions, such as management earnings forecasts, has been one of the central topics in the accounting, finance, and economics fields. In this case, the quality of information is generated from audited financial reports. The substitute hypothesis states that firms with better information quality of audited financial reports decreases the willingness or probability of firms to disclose information voluntarily. On the other hand,

the confirmation hypothesis proposes that financial reports and voluntary disclosures of the firm's private information serve as tools for firms to communicate with outside investors. Furthermore, the confirmation hypothesis suggests that the interactions between audited financial reporting and voluntary disclosure information should be taken into consideration in empirical studies.

2.5 Management earnings forecasts

Management earnings forecasts are voluntary managerial disclosures predicting earnings prior to the earnings announcement date (King, Pownall, and Waymire 1990). Based on the categorization of the Stock Exchange of Thailand (SET), management earnings forecasts are classified as optional disclosures. Optional disclosures refer to publicly-released information or news related to firms' financial projections and probable important future events. Such financial projections or forecasts (i.e., forecasted earnings per share, quarter earnings forecast, annual earnings forecasts) represent one of the key voluntary disclosure mechanisms by which managers establish or alter market earnings expectations, preempt litigation concerns, and influence their reputation for transparent and accurate reporting (Hirst, Koonce, and Venkataraman 2008).

Prior research pertaining to information content of management earnings forecast showed that earnings forecast disclosures reduced information asymmetry problems (Ajinkya and Gift 1984; Kasznik and Lev 1995; Frankel, McNichols, and Wilson 1995; Coller and Yohn 1997). An empirical evidence claimed that equity investors and sell-side analysts closely monitored firms' management earnings forecasts (Baginski and Hassell 1990; Pownall, Wasley, and Waymire 1993).

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

Prior literatures on management earnings forecasts provided an obvious determinate regarding management credibility and a quality of financial disclosure. For example, Williams (1996) found that managers established a forecasting reputation based on the accuracy of prior earnings forecasts and that accuracy served as an indicator about the believability of a current management forecast. Skinner (1994) suggested that managers have reputational incentives to preempt negative earnings news. Skinner (1994) also speculated that firms that fail to release bad news in a timely manner are less likely

to be followed by financial analysts. Williams (1996) and Skinner (1994) argued that managers have the incentive to be conservatively biased in their forecasts because the risk of litigation is believed to be greater when managers are erroneously optimistic (i.e., litigation risk is asymmetric).

Studies identified additional factors associated with forecast accuracy or errors. Earnings forecast error or bias are defined as the differential between actual earnings and forecast earnings. Brown's (1988) analysis suggested that the degree in accuracy of management earnings forecasts could be the result of deferrals, accruals, and the adoption of discretionary accounting changes that reduce forecast errors. McNichols (1989) found that management earnings forecasts contain predictable errors in relation to historical stock returns, suggesting that managers fail to efficiently incorporate information contained in past stock prices into their earnings forecasts. Ajinkya, Bhojraj, and Sengupta (2005) and Karamanou and Vafeas (2005) stated that firms with superior corporate governance tend to provide more accurate and less biased forecasts.

With a sample time period of 1997 to 2002, Ajinkya, Bhojraj, and Sengupta (2005) studied the relationship between corporate monitoring proxies (i.e., outside directors and institutional investors) and properties of earnings forecasts that were publicly announced by firm managers. The properties of earnings forecasts were the likelihood of forecast occurrence, frequency, specificity, accuracy, and bias of forecasts. Results showed that both governance proxies, specifically institutional ownership and the proportion of outside directors, are related with the probability of forecast occurrence and frequency of forecast issuance. The forecasts that were issued are also found to be more specific and accurate. Furthermore, the relationship between governance mechanisms and managerial optimism is found to be negative. In other words, firms that have greater institutional ownership and a higher percentage of outside directors tend to issue forecasts that are less optimistically biased.

Karamanou and Vafeas' (2005) study looked into corporate boards and audit committees and their association with management earnings forecasts. The results showed that firms with board and audit committee structures are highly effective, managements are more likely to issue or update their earnings forecasts, make forecasts

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

with less precise figure yet with greater accuracy, and tend to draw more favorable responses from the market. According to the results, the relationship between effective governance and the tendency of management forecasts is stronger when negative news exist. Empirical evidence from Karamanou and Vafeas' (2005) study suggested that the effectiveness of corporate governance is positively related with the quality of financial disclosure.

Prior studies also proposed various incentive-related factors that could motivate managers to bias their earnings forecasts. Rogers and Stocken (2005) reported that forecast errors are not random and that they vary with management incentives and the market's ability to detect the forecast bias. They suggested that managers whose firms are in financial distress, in particular, may issue optimistic forecasts to temporarily convince investors that they are implementing a sound business plan in order to keep their jobs and to reduce the probability of bankruptcy or a hostile takeover. Skinner (1994, 1997) and Baginski, Hassell, and Kimbrough (2002) found that managers tend to bias their earnings forecast to reduce firm's expected legal costs. In addition, Lang and Lundholm (2000) found that firms issuing earnings forecasts around equity offerings are optimistically biased.

Gong, Li, and Xie (2009) found that managers tend to forecast subsequent year earnings more optimistically (pessimistically) when current year accruals are relatively high (low). In addition, it was found that the positive association between management earnings forecast errors and accruals is stronger for firms operating in a more uncertain business environment and for firms exhibiting greater covariation between accruals and employee growth. Furthermore, this positive association is significant when accruals reflect a manager's true beliefs about the firm's business prospects but is nonexistent when accruals are manipulated to boost the manager's trading gains. These findings suggested that the manager's misassessment of the firm's business prospects results in a positive relationship between management forecast errors and accruals. The findings from this research were consistent with that of Hirshleifer (2001) and Zhang (2007), who argued that an uncertainty in the operating environment can exacerbate management's cognitive biases in processing information.

Copyright© by Chiang Mai University
All rights reserved

Another stream of research suggested that managers tend to issue forecasts that are said to be pessimistic biases as a large number of actual earnings are found to be higher than the earnings forecasted by managers. The rationale behind it is that managers tend to issue forecasts that are downward-biased in comparison to the manager's real expectations with the purpose of lowering investors' expectations before the actual earnings are publicly announced. The purpose of lowering investors' expectations is to reduce the probability of a negative earnings shock on the earnings announcement date (Matsumoto 2002; Cotter, Tuna, and Wysocki 2006; Bergman and Roychowdhury 2008). Although the initial negative expectations may be perceived as bad news, the low expectations make it easier for firms to satisfy investors with higher actual earnings or beat the consensus earnings forecast. A prior study also suggested that investors tend to give more importance to the announcements of actual earnings than to prior news releases made on the forecasts and subsequent changes in expectations after the initial announcements (Bartov, Givoly, and Hayn 2002). Therefore, the perception of the firm's actual earnings are evaluated as positive by investors.

In conclusion, prior studies on management forecasts provided evidence that earnings forecasts are informative about the firm's value (Patell 1976; Penman 1980; Pownall, Wasley, and Waymire 1993; Nagar, Nanda, and Wysocki 2003; Hutton and Stocken 2006). More recent studies focused on examining the factors that influence the issuance of forecasts (Rogers and Stocken 2005; Hutton and Stocken 2006), and the effects of forecast characteristics on stock price changes (Atiase et al. 2005) and analyst behavior (Libby, Tan, and Hunton 2006). However, there are relatively few empirical evidence (Ajinkya, Bhojraj, and Sengupta 2005; Gong, Li, and Xie 2009) on the determinants of forecast characteristics, particularly bias in management earnings forecasts.

2.6 Empirical studies on accounting conservatism in Thailand

The contracting and monitoring role of accounting conservatism is an important issue in the accounting standard setting and practices. The role of accounting conservatism remains an interesting issue in accounting research (Basu 1997; Watts 2003; Armstrong, Guay, and Weber 2010). However, there are inconclusive findings in existing

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

research with respect to accounting conservatism and its determinants of the companies in Thailand. Ball, Robin, and Wu (2003) examined conservative reporting practiced among four East Asian countries (Hong Kong, Malaysia, Singapore and Thailand) during the period of 1984-1996. They found that earnings reports by Thai listed firms did not reflect conservative accounting method choice because they were less likely to recognize bad news over good news. On the other hand, Bushman and Piotroski (2006), studied 38 countries (including Thailand) during the period 1992-2001. Interestingly, they found that Thai listed firms adopted the conservative accounting method choice.

Using a data set of Thai listed firms, Boonlert-U-Thai and Kuntisook (2009) examined the effects of controlling shareholders characteristics on financial reporting conservatism. They categorized controlling shareholder characteristics into founding family firms and family firms using a sample of 1,733 firm-years of Thai listed companies during 2000-2006. Boonlert-U-Thai and Kuntisook (2009) hypothesized and found that conservatism, as measured by asymmetric timeliness of earnings, increases with greater controlling shareholder ownership in founding family firms and family firms. Therefore, the results support the alignment incentive effect of concentrated ownership. Importantly, Boonlert-U-Thai and Kuntisook (2009) also found that the effect is higher for founding family firms as compared to family firms.

Copyright© by Chiang Mai University
All rights reserved

Using fifty-four companies that issued bonds continually during 2003 and 2005 period, Tangpanyatorn and Peetathawatchai (2010) examined whether accounting conservatism played an important role in mitigating bondholder-shareholder conflicts over dividend policy, and in reducing firms' debt costs in an environment of emerging stock and bond markets in Thailand. The research provided weak evidence that accounting conservatism helped to mitigate bondholder-shareholder conflicts over dividend policy. Only the market-based measure of conservatism was significantly positively associated with one proxy of bondholder-shareholder conflicts (dividend-to-asset ratio). In contrast to Ahmed et al.'s (2002) suggestion,[7] Tangpanyatorn and

[7] According to Ahmed et al. (2002), accounting conservatism can help alleviate conflicts between bondholders and shareholders concerning dividend policies. It was found that,

Peetathawatchai (2010) stated that Thai firms with more conservative accounting were found to have lower debt ratings (proxies for firms' cost of debts). These results suggested that accounting conservatism does not have an important role in debt contracts in Thai emerging market which is inconsistent with the findings from developed markets, such as the United States. Tangpanyatorn and Peetathawatchai (2010) argued that the possible explanation is that in emerging stock markets, listed firms might focus on increasing firm values through returns-earnings relations rather than mitigation of bondholder-shareholder conflicts over dividend policy.

In conclusion, studies on accounting conservatism in Thailand are still limited and lacks empirical findings in regard to the role of conservative financial reporting in providing information to the capital market. The existing studies focus on investigating contracting demand for conservatism. Therefore, conducting a study in the Thai context, where the institutional environment is different from developed countries, served as a contribution in studying the valuations implications of accounting conservatism and its effects on management earnings forecast disclosure practices. As the Thai Accounting Standard (TAS) complies with the International Financial Reporting Standards (IFRS), the analysis on the relationship between conservative financial reporting and voluntary management forecast disclosures of Thai listed firms could be compared with studies in Western countries.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved

2.7 Empirical studies on management earnings forecast disclosure in Thailand

The majority of existing studies on management earnings forecast are limited to US firms. There is a dearth of empirical evidence related to management earnings forecast disclosure in the Thai context. More recent studies on management forecast disclosure practices in Thailand state that management forecast disclosures practices of Thai listed firms have an increasing trend (Jarutakanont and Supattarakul 2012) and forecasted information are informative (Jarutakanont and Supattarakul 2013).

---

after controlling for other predictors of costs of debt, firms with more conservative accounting tend to incur a smaller amount of cost of debt.

Jarutakanont and Supattarakul (2012) provided empirical evidence on management forecast disclosure practices in Thailand. Their research sample included 4,483 management forecast disclosures of listed companies in the Stock Exchange of Thailand (SET) during January 2005 – June 2007. According to the results, almost 70% of Thai listed companies voluntarily disclosed their management forecasts, and over 60% of forecast firms disclosed more than five forecasts within a one-year period. Despite the forecast horizon, approximately 70% of the total number of management forecasts were disclosed prior to, instead of after, the last day of the accounting period. In addition, it was found that quarterly forecasts were issued by firms around six weeks before or three weeks after the end of the accounting period. On the other hand, annual forecasts were issued six months before or one month after the end of the accounting period. Also, of all the forecasts issued, 46% were stand-alone annual, 10% were stand-alone quarterly, while 44% were concurrent annual-quarterly.

Jarutakanont and Supattarakul (2012) also concluded that despite forecast horizons, firms were found to have more tendencies of issuing revenue forecasts than earnings forecasts. In addition, the majority of quarterly revenue and earnings forecasts were found to be in semi-numeric and qualitative forms. Most of the forecasts on annual revenue were in point estimate and semi-numeric form while the majority of forecasts on annual earnings were in qualitative form.

In their 2013 article, Jarutakanont and Supattarakul examined whether the market reacted to the management earnings forecasts of Thai listed companies. The study obtained management earnings forecast disclosures of companies from the same sample used in their previous study (Jarutakanont and Supattarakul 2012). The results revealed that the magnitude of cumulative market-adjusted abnormal returns surrounding management earnings forecast dates are significantly greater than zero. Market reactions to good news forecasts were significantly greater than market reactions to bad news firms, regardless of industry, forecast timing, and forecast horizon. Overall, this research showed that management earnings forecasts of Thai listed firms are informative.

ลิขสิทธิ์มหาวิทยาลัยเชียงใหม่
Copyright© by Chiang Mai University
All rights reserved