

THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND EARNINGS QUALITY : A CASE STUDY OF LISTED COMPANIES IN THE STOCK EXCHANGE OF THAILAND (SET)”

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Abstract:

A good earnings quality is very significant as it leads to the effective disclosure and accordingly good corporate governance. This research attempts to utilize the association of newly-created Corporate Governance which measures from the Corporate Governance Scores of the Thai Institute of Directors (IOD) in the Stock Exchange of Thailand (SET) in the year 2011 as independent variable, which the higher IOD score usually reflect the higher level of Corporate Governance and earnings quality as the dependent variable which used the variance and risk, which measured using standard deviation. Standard deviation is a standard measure of investment risk. This IOD's score compares almost all listed firms with the criteria established in the principles of corporate governance. The chi-square was used to test this relationship at 95% confidence. Results of analysis highlights that the standard deviation of firms listed in the SET for year 2011 is have the associated with IOD Score. In summary, the high Corporate Governance measured by IOD score shows earnings quality. In this study means that the firm which has a high IOD score, which means high corporate governance will have earnings quality which measure by using standard deviation. However, the results of this study shows the relationship between the two variables. The reason behinds this result may due to the fact that eventhough there are many ways to measure quality earnings, for our study, we use only standard deviations to measure earnings quality.

Keywords: corporate governance, earnings quality, standard deviation, and SET Thailand.

1. INTRODUCTION

In recent times, a growing number of scams and corrupt practices have taken place. Mismanagement and misappropriation of public money are occurring unremarkable worldwide. It is occurring in the stock exchange, banking institutions, organizations and government offices. Corporate governance after the failure of huge companies like Enron and WorldCom once more as one of the most essential business dilemma stated.

As the 1997 financial crisis broke and washed over Thailand, it became apparent that weak corporate governance practices could have intensified the severity of the problems. A close examination of corporate governance practices of many Thai firms would have revealed that local governance practices did not match international standards and expectations, and poor governance practices. As one consequence of poor governance practices, many firms faced financial distress, to be resolved through bankruptcy proceedings or aggressive financial restructuring (PimanLimpaphayom and J. Thomas Connelly, 2004). Poor governance practices played a major role in Thailand corporate governance difficulties.

Furthermore, failure of firm occurs also if financial statement does not comply with accounting standard which is called "TFRS" and weak internal control system that leads to creative accounting. Creative accounting can lead to suspicion, audits by the government and fraud may be adopted subsequently. In order to cut down the likelihood of using creative accounting and fraud, effective corporate governance is in great need. The term creative accounting as generally understood refers to a systematic misrepresentation of the true income and assets of corporations or other organizations. "Creative accounting" is at the root of a number of accounting scandals, and many proposals for accounting reform - usually centering on an updated analysis of capital and factors of production that would correctly reflect how value is added. Zubaidur Rahman (2000) emphasized that it is necessary to recognize the relevance of quality financial reporting as an economic fundamental which not only shapes financial transparency and accountability of the corporate sector and plays a crucial role in ensuring good corporate governance, but also provides an important link in the national and international financial construction.

To avoid these scams and economical irregularities, many organizations have started corporate governance. Nowadays, decision makers concede that the issue of corporate governance concepts can uphold resolve in financial markets, vitalize investment and also it leads successful growth. One of the most important tasks of corporate governance also ensured the quality of financial reporting. Furthermore, corporate governance is one factor that can reduce agency costs; therefore, by filtering through the limiting opportunistic behavior of management, can lead to improve quality and reliability of reporting and also increases the value of the company.

The basic principles of corporate governance are accountability, responsibility, equitable treatment, transparency, vision, and ethics. Further most of the basic principles of corporate governance performs by numerous Thai firms were reasonably correlated to the international Organization for Economic Cooperation and Development (OECD) guideline standards and anticipations. Therefore, an organization who responsible in controlling firm Stock Exchange (SEC) issues corporate governance regulation to control firm listed on the Stock Exchange of Thailand (SET).

The Thai Institute of Directors (Thai IOD) and McKinsey & Company Thailand, in collaboration with The Stock Exchange of Thailand (SET) and the Office of the Securities and Exchange Commission (SEC), jointly launched an effort to standardize governance practices of the listed Thai companies. The IOD founded in 1999, two years succeeding the 1997 Asian financial crisis, a leading organization dedicated to improving director professionalism and directed corporate governance assessment of Thai listed companies. The whole assessment outcomes were circulated in the reports titled "Corporate Governance Report of Thai Listed Companies (CGR)". The reports have assisted Thai companies to significantly develop their corporate governance practices over the years, and in the hope that the corporate governance standards of Thai companies will be keen and accordingly advantage the companies and investors equally with specific objectives: (1) to study and follow up the development of corporate governance practices of Thai listed companies, (2) To publicize a report on corporate governance performance of Thai listed companies, and provide recommendation for improvement, (3) To provide inputs for regulator agencies in formulating corporate governance framework, (4) To provide customized Company Corporate Governance Assessment Report &

Recommendations for individual companies interested in developing corporate governance practices, and (5) to make use of results in other activities to promote good corporate governance such as the selection of board of directors for the Board of the Year Awards by the IOD.

The scoring information sources are from: company annual report, annual information filing (Form 56-1), notice and minutes of companies' shareholders meeting, company website, information on SET/SEC database, and other publicly available information. In order to ensure that the criteria used in the study is in line with international standards and best practices, a Steering Committee was established to review and comment on the evaluation template. The Committee comprises of experts from numerous market segments.

One of the most powerfully important tasks of corporate governance assured the quality of financial reporting. Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency (IASB, 2006; IASB, 2008). The earnings number acts as a summary measure of a firm's performance. Thus it is crucial that the earnings number reported in a firm's financial statements is reliable, relevant and free from manipulation. As stated by Barragato and Markelevich (2008) earnings quality is of interest to users of financial statements because earnings, and the varied metrics derived from, are utilized in making contracting and investment decisions. From a contracting perspective, low-quality earnings may result in unintended wealth transfers. From an investor's vantage point, low-quality earnings are undesirable because they result in a defective resource allocation signal (Schipper and Vincent, 2003). This is also supported by Myers, Myers and Omer (2003), who state that poor quality of earnings is problematic because it can mislead investors, resulting in misallocation of resources.

Additionally, factors that investor must concentrate is the quality of accounting information. A manifestation of extreme distortion and asymmetry in the information environment is the incidence of accounting fraud or accounting misstatements which is reasonably distinct from more benign informational issues stemming from incomplete and/or untimely disclosure or financial reporting (Christopher S. Armstrong et al., 2009). Accounting information plays a vital role in corporate governance. With accounting information, organizations are able to calculate a company's financial position, make appropriate use of resources, and plan how to take the company forward in the future. If the financial statement is reliable it will make earnings quality. Barua (2006) considered two criteria for measuring the earnings quality. These two criteria are relevance and reliability.

For Thailand, we reviewed from Pimonporn Vanittanon (2010), her topic is "The Relationship Between the Principle of Good Corporate Governance and the Quality of Earnings : A Case Study of Listed Companies in Resources Group", the objective of this study is to investigate the practices of good corporate governance of listed companies in the stock exchange of Thailand from 2006 to 2008 : resources group and the quality of earnings. In addition, the study investigate of the relationship between the good corporate governance and the quality of earnings of those companies. The study indicates that the disclosure toward good corporate governance of the listed companies in resources group is a fair level. The majority of the disclosure in the group of rights of shareholders and the role of stakeholders is the least disclosure. In addition, the study shows that there is no relationship between the good corporate governance and the quality of earnings.

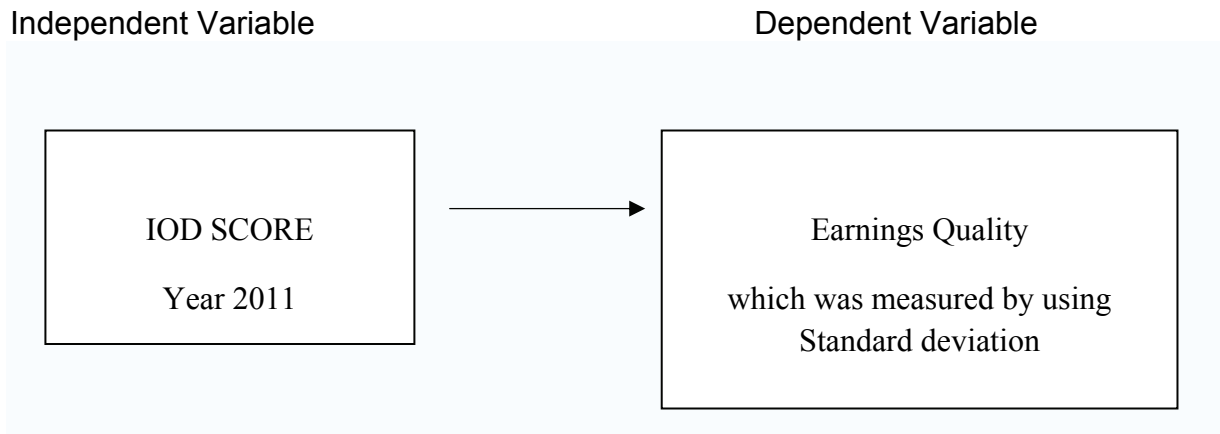
Earnings quality is one of the most important characteristics of financial reporting systems. High quality is said to improve capital market efficiency, therefore investors and other users should be interested in high-quality financial accounting information. For that reason, standard setters strive to develop accounting standards that improve earnings quality, and many recent changes in auditing, corporate governance, and enforcement have a similar objective.

Given the above description, this study examines whether IOD score will affect the earnings quality using the firm listed in (Stock of Exchange of Thailand) SET for the year 2011. Specifically, the study aims to determine the relationship of earnings quality and IOD score using standard deviation. The results of this study lead investors and stakeholders to make their investment decisions better, also the results will direct the institute sector to make regulation to organize the good corporate governance of the firms listed in the SET.

1.1 Theoretical Background and Hypotheses Development

A number of studies based on the impact on corporate governance and earnings quality claimed that the earnings quality has the relationship with the corporate governance. Various researches were conducted from a number of methodologies. The conceptual framework of this study is identified below.

Figure 1: Conceptual Framework



To measure earnings quality using standard deviations, the less flexibility of net income will demonstrate the less risk, which it shows the good earnings quality. The more standard deviation, the less earnings quality. In this study the standard deviation was calculated as follows:

$$s = \sqrt{\frac{\sum(x - \bar{x})^2}{N - 1}}$$

Where:

- s = standard deviation
- x = net income of the year
- \bar{x} = Average of net income
- N = the number of the year

To obtain IOD score, Thai listed companies are evaluated according to 5 main categories derived from the OECD principles of corporate governance: (1) Rights of Shareholder, (2) Equitable Treatment of Shareholders, (3) Role of Stakeholders, (4) Disclosure and Transparency, and (5) Board Responsibilities. To make an objective assessment of each company, the Thai IOD created a corporate governance template containing 132 individual questions as a scoring tool. In the scoring template, there are 25 questions covering Rights of Shareholders, 14 questions assessing Equitable Treatment of Shareholders, 10 questions on the Role of Stakeholders, 33 questions on Disclosure and Transparency, and 50 questions on Board Responsibilities. Section weights are first assigned to each of the five corporate governance categories. Then, within each category, individual weights are assigned to each question. This proprietary two-tier weighting system is established by a panel of experts.

The corporate governance scores can be distributed into five groups, the IOD only provides information of the firms that receive higher grades than "Fair." Hence, the public information that investors could obtain each year is only for the top three corporate governance groups. Based on this information, this study, then, classifies other listed firms that were traded in the same year but did not get their name on the IOD report under the new group labeled "Poor." Therefore, the analyses in this study will focus on the four corporate governance score groups that are labeled from strongest to weakest practice as excellent (level 5), very good (level 4), good (level 3), and poor or no assessment (level 0).

The independent variable was defined to examine the relationship between (corporate governance) IOD score and earnings quality using a standard deviation measure, which approaches from literature reviews and can be explained as follows:

Numerous of studies on earnings quality and corporate governance in the academic journals (Wang, 2006; Lara, et al., 2007; Machuga and Teitel, 2007; Chang and Sun, 2009; Machuga and Teitel, 2009). These have, at least in part, being motivated by the economic crisis and business failures that happened world-wide (Cohen, et al., 2004; Rahman, 2006; Yew Ming, et al., 2007; Habib and Azim, 2008). Such studies become more relevant as businesses are increasingly concerned about having sufficiently strong corporate governance mechanisms to ensure high quality of financial reporting.

Earnings as an estimator of profit, is then defined by standard accounting procedures. Quality earnings are characterized as unbiased estimates of expected, or persistent, profit. The level of quality is measured by how closely the time averaged variance, or volatility, of earnings approximates the variance of profit, i.e. the profit at risk (Roger J. Willett, 2012).

Jiang W. et al., (2008) suggested that only firms in the highest category of corporate governance experience significantly improved quality of earnings, as a test of robustness, they documented that corporate governance is negatively associated with small earnings surprises. This implies that firms with weak corporate governance are more likely to manage earnings in order to meet or beat analyst forecasts. Furthermore, only firms in the highest category of corporate governance experience significantly improved quality of earnings (Klein, A., 2002).

Brown and Caylor (2004), in their paper 'Corporate Governance and Firm Performance', created a measure of corporate governance ('Gov-Score'), based on data provided by Institutional Shareholder Services. GovScore comprised 51 factors covering eight corporate governance categories: audit; board of directors; charter/bylaws; director education; executive and director compensation; ownership; progressive practices; and state of incorporation. For over 2,300 firms, Brown and Caylor relate Gov-Score to six performance measures over three categories: operating performance (return on equity, net profit margin, sales growth); valuation (Tobin's Q); and shareholder payout (dividend yield, stock repurchase). This study found that better governed firms were relatively more profitable, more valuable and paid out more cash to shareholders, while poorly governed firms had lower operating performance and paid out less cash to shareholders. Additionally, Brown and Caylor found that firms with independent boards had higher returns on equity, higher profit margins, larger dividend yields and larger stock repurchase. They went on to suggest that limiting board size leads to improved firm performance as the increased monitoring benefits of larger boards were outweighed by poorer communication and decision making.

In accounting, if the net income is stable and not fluctuating, it has significantly lesser risk because risk is positively correlated with income, the higher the income the higher the risk. Also, if the standard deviation is high the earnings quality is low. Thus, according to the research this hypothesis arise:

H₀: The standard deviation of firms listed in the SET for year 2011 is not associated with IOD Score.

2. RESEARCH DESIGN

In this research, the causal or explanatory approach will be applied. A panel data analysis will be conducted in this study. The sample size will be collected in Thailand SET during year 2011. To examine the association between corporate governance and earnings quality, we used the SPSS program and chi-square test at 5% significance level. For testing the relationship, we divided the firms into 2 group by using median of standard deviation, we designed the high risk firms if the firms get higher standard deviation than the median of standard deviation , otherwise the low risk firms if the firms get lower standard deviation than the median of standard deviation.

3. THE EMPIRICAL RESULT AND ANALYSIS

To study the relationship between IOD Score and earnings quality of the firm listed on the SET of year 2011. The following table was shown the results of this study.

Table 1: The Descriptive of IOD Score

| Industry | Level 0 | Level 3 | Level 4 | Level 5 | Total |
|---------------------------|-------------------|-------------------|-------------------|-----------------|--------------------|
| | x (%) | x (%) | x (%) | x (%) | x (%) |
| Agro and Food Industry | 12 (30.7) | 8 (20.5) | 18 (46.2) | 1 (2.6) | 39 (100.0) |
| Resource | 4 (14.9) | 8 (29.6) | 6 (22.2) | 9 (33.3) | 27 (100.0) |
| Industrials | 31 (40.4) | 26 (33.9) | 17 (22.1) | 3 (3.6) | 77 (100.0) |
| Consumer Products | 15 (38.5) | 12 (30.7) | 11 (28.2) | 1 (2.6) | 39 (100.0) |
| Property and Construction | 25 (32.1) | 26 (33.3) | 20 (25.6) | 7 (9.0) | 78 (100.0) |
| Services | 25 (29.8) | 26 (31.0) | 23 (27.4) | 10 (11.8) | 84 (100.1) |
| Technology | 10 (26.3) | 10 (26.3) | 15 (39.5) | 3 (7.9) | 38 (100.0) |
| Total | 122 (31.9) | 116 (30.4) | 110 (28.8) | 34 (8.9) | 382 (100.0) |

Table 1 presents the results of descriptive statistics of IOD Score. The table shows the result of the IOD score of each industry with their level respectively: the agro and food industry at level 4 with (46.2%)18 , the resources at level 5 with (33.3%) 9, the industrials at level 0 with (40.4%) 31, the consumer products at level 0 with (38.5%) 15, the property construction at level level 3 with (33.3%) 26, the services at level 3 with (31.0%) 26, and the technology level 0 and level 3 with (26.3%) 10. Focusing on the highest and the lowest IOD score of each level of industry: at level 0 the property and construction (32.1%) 25 is the highest and the resources (14.9%) 4 is the lowest. At level 3 the industrial (33.9%) 26 is the highest and the agro and food industry (20.5%) 8 is the lowest. At level 4 the services (27.4%) 23 is the highest and the resources (22.6%) 6 is the lowest. At level 5 the services (11.8%) 10 is the highest and the agro and food industry (2.6%) 1 and consumer products (2.6%) 1 is the lowest respectively.

Table 2: The Descriptive Statistics for Standard Deviation

| Industry | Max | Min | \bar{X} | S.D. |
|---------------------------|----------------|-------------|---------------|---------------|
| Agro and Food Industry | 6958110252.41 | 27611520.41 | 457901775.11 | 1145508957.18 |
| Resource | 27297956519.50 | 47278164.65 | 3778029631.19 | 6900033259.47 |
| Industrials | 5913484589.43 | 12081207.45 | 329171240.24 | 808276559.00 |
| Consumer Products | 1146279494.77 | 7474959.35 | 142763439.42 | 213121676.13 |
| Property and Construction | 13321124664.21 | 28802271.32 | 630898288.53 | 1622716309.70 |
| Services | 15046645604.85 | 1406725.66 | 747824184.83 | 2092786820.64 |
| Technology | 5241410221.40 | 31568995.58 | 944194974.92 | 1506671808.50 |

Table 2 presents the results of descriptive statistics of standard deviation. The results show that the average of the standard deviation of Agro and the food industry is 457901775.11 and its standard deviation is 1145508957.18 which is the lowest among other industry, the minimum is 27611520.41 and the maximum is 6958110252.41. The average of resource industry is 3778029631.19 and its standard deviation is 6900033259.47, the maximum is 27297956519.50 and the minimum is 47278164.65. The average of industrial industry is 329171240.24 and and its standard deviation is 808276559.00 which is the highest among other industry, the maximum is 5913484589.43 and the minimum is 12081207.45. When focusing on the average of consumer products industry, it shows that the average is 142763439.42 and its standard deviation 213121676.13 which is lowest among other industry,with the maximum of 1146279494.77 and the minimum of 7474959.35. The average of property and construction industry is 630898288.53 and its standard deviation 1622716309.70, the maximum is 13321124664.21 and the minimum is 28802271.32. The average of services industry is 747824184.83 and its standard deviation 2092786820.64, the maximum is 15046645604.85 and the minimum is 1406725.66. Furthermore, the average of the technology industry is 944194974.92 and its standard deviation 1506671808.50, which is the highest among other industry with the maximum of 5241410221.40 and the minimum of 31568995.58.

This revelation shows that the Resource industry with a high standard deviation (3778029631.19) is high risk which show low earnings quality; whereas, the Consumer Products industry with a low standard deviation (142763439.42) is low risk which shows high earnings quality.

Table 3: Chi-Square result for the Relationship of IOD Score and Standard Deviation

| CG | S.D. | | | | χ^2 | p |
|----|-----------------|---|------------------|------|----------|---|
| | Lower than Mean | | Higher than Mean | | | |
| | n | % | n | % | | |
| | | | | 8.16 | .043* | |

| | | | | | | |
|---------|-----|-------|----|-------|--|--|
| Level 0 | 106 | 86.18 | 17 | 13.82 | | |
| Level 3 | 95 | 90.48 | 10 | 9.52 | | |
| Level 4 | 91 | 82.73 | 19 | 17.27 | | |
| Level 5 | 32 | 72.73 | 12 | 27.27 | | |

* significant .05

Table 3 presents the chi-square result of the relationship of IOD score and standard deviation. The results show that the IOD score which measure the corporate governance is significantly in relation to the standard deviation which measure the earnings quality (Chi-square = 8.16, p-value < 0.05). Thus, the hypothesis is rejected; that the standard deviation of firms listed in the SET for year 2011 is associated with IOD Score. This revelation shows that the firm which has a high IOD score also has high good corporate governance and will have high quality earnings which measure of standard deviation.

In other words, good quality earnings and good corporate governance are positively related with each other. Similarly, Jiang et al. (2008) studied the association between corporate governance and earnings quality. Their results suggest that only firms in the highest category of corporate governance experience significantly improved quality of earnings. They document that corporate governance is negatively associated with small earnings surprises. Their findings imply that firms with weak corporate governance are more likely to manage earnings in order to meet or beat analyst forecasts. Also, Sivaramakrishnan and Shaokun (2008) as they suggested that the corporate governance is adequate, regardless of the strength of governance, earnings quality is high, that the firms with adequate governance tend to have high accrual quality, high earnings persistence, and high earnings predictive ability, given the same level of corporate governance and they concluded that the adequacy of corporate governance is a significant determinant of earnings quality.

Belen Blanco Pelaez et.al (2009) concluded that the firms with better earnings quality have incentives to provide more comprehensive segment information, but this complementary relation only holds above some threshold level of earnings quality; and (2) provide empirical evidence supporting that through better segment disclosure and better earnings quality investors are better able to estimate firm's cash flows more accurately, and, as a result, firms providing better segment disclosure, especially when complemented with good earnings quality, are rewarded with a lower cost of capital.

Good corporate governance (GCG) in a corporate set up leads to maximize the value of the shareholders legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder – the company's customers, employees, investors, vendor-partners, the government of the land and the community (Murthy, 2006). The importance of good Corporate Governance has also been increasingly recognized for improving the firm's competitiveness, better corporate performance and better relationship with all stakeholders (Tiwary et. Al, 1998).

3.1 Analytical Results

This study investigated how the relationship between corporate governance using IOD score in the report entitled "Corporate Governance Report of Thai Listed Companies 2011" in the Thai Institute of Directors Association (Thai IOD) and earnings quality measured by using standard deviation. The results of corporate governance scores and earnings quality show that the most listed companies about 31 percent of total listed firms, as poor (level 0) or no assessment of the Thai IOD. Therefore, firms should focus on the good corporate governance practices and join the assessment of the Thai IOD.

Results of analysis highlight that the standard deviation of firms listed in the stock Exchange of Thailand (SET) for the year 2011 has associated with IOD scores at 5 percent significance level. Consistent with Jiang, Lee and Anandarajan (2008) studied the relationship between corporate governance and earnings quality measured by using corporate governance scores and this result that the firm has high corporate governance scores will be lower earnings management and earnings quality will be higher. This study results is conflicted with Pimonporn Vanichthananon (2008) studied the earnings quality of firm in the resource sector in the SET is not having the associated with good corporate governance.

Nevertheless, the different results may due to measure techniques of earnings quality or the principles of good corporate governance of Thailand.

4. CONCLUSIONS

The newly created IOD's score proved to strengthen the corporate governance in the Stock Exchange of Thailand (SET) associated with good earnings quality. A good earnings quality is one of the radical elements that lead to a good corporate governance. It reflects current operating performance, a good sign of future operating performance, and fairly annuitizes the essential value of the company. Without a doubt, accounting will demonstrate us the way to ensue with corporate governance where bad governance generally comes from financial dissatisfaction and over exercising of power.

The insight of good corporate governance is a significant factor of the entire image of an institution, whether public, private, or nonprofit as an indication the good corporate governance yields a direct economic value to the organization. The trustworthiness obtained by good corporate governance measures also helps maintain the trust and confidence of investors both foreign and domestic to attract longer term capital. This will eventually encourage more established sources of financing and leads to developed market valuation.

Recommendation

1. The results of this study show that there is a relationship between IOD score and standard deviation of net income. In this study, IOD score and standard deviation of net income are used as measures for degree of corporate governance and earnings quality; therefore, there is a relationship between corporate governance and earnings quality of listed companies in the Stock Exchange of Thailand (SET). This information is very useful for investors and stakeholders for the investors and the stakeholders in making their investment decisions.
2. To study earnings quality, there are numerous approaches for measuring earnings quality of listed companies. Different approaches could result in different earnings quality. As a result, the researcher should truly understand the objectives and limitations of each measurement tools, so that the most suitable method could be selected.
3. Listed companies should follow OECD (OED principles of corporate governance) in order to show its transparency and accountability. This would, consequently, result in a higher confidence level among Thai and foreigner investors.

Recommended for further study

1. This research used the standard deviation of net income as a measure of earnings quality. In a further study, different measurement approaches such as variance coefficient and discretionary accruals could be applied.
2. Similarly, there might be other factors that affect the degree of corporate governance besides IOD scores. The researcher could take other factors into consideration in the future research.

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