

ความสัมพันธ์ทางการเมืองกับคุณภาพของรายได้

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วิทยานิพนธ์นี้เป็นส่วนหนึ่งของการศึกษาตามหลักสูตรวิทยาศาสตรมหาบัณฑิต

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ลิขสิทธิ์จุฬาลงกรณ์มหาวิทยาลัย

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POLITICAL CONNECTION AND EARNINGS QUALITY

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A Thesis submitted in Partial Fulfillment of the Requirements
for the degree of Master of Science Program in Finance
Department of Banking and Finance
Faculty of Commerce and Accountancy
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พรรณธิดา ศรีสุวรรณันท์ : ความสัมพันธ์ทางการเมืองและคุณภาพของรายได้ (POLITICAL CONNECTION AND EARNINGS QUALITY) อ.ที่ปรึกษาวิทยานิพนธ์หลัก : รศ.ดร. สันติ ธิรพัฒน์ 59 หน้า.

วิทยานิพนธ์ฉบับนี้มุ่งศึกษาความสัมพันธ์ทางการเมือง ซึ่งจากการค้นคว้าต่างๆระบุว่าให้ประโยชน์แก่บริษัทที่มีสายสัมพันธ์ทางการเมืองเมื่อเปรียบเทียบกับบริษัทที่ไม่มีความสัมพันธ์กับภาคการเมือง วิทยานิพนธ์ฉบับนี้ให้ความสำคัญกับการศึกษาผลประโยชน์ที่บริษัทได้จากความสัมพันธ์ทางการเมืองที่มีต่อคุณภาพของข้อมูลเชิงรายได้ ต้นทุนการเป็นหนี้ และปฏิภริยาที่ตลาดมีต่อการรายงานผลประกอบการรายปีของบริษัท จากการใช้เกณฑ์คงค้างทางบัญชีตรวจสอบความสัมพันธ์ระหว่างความสัมพันธ์ทางการเมือง และคุณภาพของรายได้ของบริษัทที่จดทะเบียนอยู่ในตลาดหลักทรัพย์แห่งประเทศไทยในช่วงปี พ.ศ. 2543 – 2551 วิทยานิพนธ์ชิ้นนี้พบว่าความสัมพันธ์ทางการเมืองทำให้คุณภาพของรายได้ของบริษัทที่มีความสัมพันธ์ทางการเมืองต่ำกว่าบริษัทที่ไม่มี และโดยเฉลี่ยแล้วบริษัทที่มีสายสัมพันธ์ทางการเมืองนั้นมีต้นทุนในการเป็นหนี้ต่ำกว่าบริษัทที่ปราศจากสายสัมพันธ์ทางการเมือง ส่วนความสัมพันธ์ทางการเมืองมีผลต่อปฏิภริยาของตลาดที่มีต่อการรายงานผลการประกอบการรายปีของบริษัทจากความรุนแรงของการขึ้นลงของราคาหุ้นนั้นไม่พบความแตกต่างที่ชัดเจนระหว่างสองกลุ่ม

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PANTIDA SRISUWORANAN: POLITICAL CONNECTION AND EARNINGS QUALITY. THESIS ADVISOR: ASSOC. PROF. SUNTI TIRAPAT, PH.D, 59 pp.

Researchers suspect that there exist political connections which provide advantages and allows politically connected firms to gain extra benefits than non-connected firms or exploit the connections to maximize their profits. This thesis isolated the quality of accounting information and market reaction toward earnings announcement to see whether they are affected by political connection. By employing accrual method to study the relationship between political connections and the quality of accounting information in terms of earnings of the firms listed on the Stock Exchange of Thailand during 2000-2008, the paper reported that political connection causes the quality of earnings to be lower in comparison to non-connected firms while political connection provides benefit in terms of having a lower cost of debt and found that connected firms have an overall lower cost of debt. Finally, we found that connected and non-connected firms have similar pattern of market reaction towards earnings announcement.

Field of Study:Finance..... Student's Signature.....

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CHAPTER I: INTRODUCTION

1.1 Background and Problem Review

As firms in the globalizing world compete to maximize their profits, they have the utmost incentive to search for economic rents and utilize the connections to the politics. It is hence not surprising that the issue of politically connected firms has increasingly been highlighted by various studies in the recent years.¹ Several researches have pointed out that political connection and rent seeking activities by firms have negative effects on economic growth in both developed and developing countries. The work of Desai and Olofsgård (2008), for instance, illustrates the types of rents or political rewards politically connected firms could extract from cronyism. It gives evidence that influential or politically connected firms in developing countries exhibit lower real growth in sales, and are less likely to issue new product lines or production facilities. In particular, countries reported to have high level of corruption, poor quality of political institution, and low investor protection are subjected to greater risk from the politicization of their economic activities. According to Transparency International's Corruption Perception Index in 1997, Thailand scored 3.06 and was ranked the 39th least corrupted country out of 52 countries examined. With a renowned reputation for corruption and its political instability, Thailand is an inducing case to investigate politically connected firms.

The main area past researchers have concentrated is the investigation, by studying the systematic exchange of favors between politicians and firms, of the extent to which political connections can create additional value to individual firms. Studies of politically connected firms in Thailand have made inquiries in the similar vein, but their conflicting and inconclusive results make the determination of overall effect of political connection difficult. Bunkanwanicha and Wiwattanakantang (2008), and Imai (2006), report strong evidences of politically connected benefits the firms gain through several accounting and stock performances. In contrary, Dusadee (2007) indicates mixed result and Udomworarat (2005) shows a contrasting conclusion that the politically connected firms do not gain value added benefits from their political connections. The explanations for the deviation of the

¹ For example, Shliefer and Vishny (1994), Fishman (2001), Johnson and Mitton (2003), and Faccio (2006).

results perhaps lie in the different time period each study was conducted, and the inherent subjectivity in interpreting and analyzing the issue of political connection. This study intends to investigate the politically connected firms in Thailand by extending the period of study to 9 years, from 2000-2008, providing a new set of database of political connection, and applying different methodology of value added analysis as opposed to looking at the stock returns and firm performances.

Reported earnings is one of the most important accounting information and they could be regarded as a primary indicator of information quality as suggested by Dechow et al (1998). The earnings quality is usually assessed by the magnitude and/or the variability of the reported accruals; the difference between a firm's earnings and the cash provided from operation. Most earnings quality researches focus on the discretionary accruals due to their particular features. They include both discretionary and non-discretionary components, and are believed to reflect managerial judgments. Chaney et al (2008) suggests that as connected firms are reported on average to gain from political ties, they would have the incentive to expropriate rent or at least obscure information from minority shareholders. They report empirical evidence that the quality of earning of the politically connected firms is significantly poorer than that of the non-connected ones. I will investigate the issue of quality of earnings on the politically connected firms in Thailand alongside with the event study of earnings announcement. The analysis of the market reaction to the earnings announcement of the connected firms would help shed the light on what form of benefits these firms attain from such connections..

1.2 Objectives of the Study

This study has three objectives as follow;

- To investigate the effect of political connection to the quality of earnings information, cost of debt, and the market reaction to earnings announcements of politically connected firms.
- To gain better understanding of politically connected firms in Thailand by conducting a longitudinal research; this study will cover the years 2000 to 2008 inclusive. Studying politically connected firms for the extended period of 9 years – a longer period in

comparison to previous researches – will also enable the firms to be scrutinized during the period of severe political instability (2005 to 2006).

1.3 Scope and Limitation

This study implements the method of event study, examining the effect of earning announcements of politically connected firms on market reaction. It also employs the definition of earning quality in terms of discretionary accruals in order to compare the quality of connected and non-connected firms' earning information. The sample includes all publicly traded Thai firms listed on the Stock Exchange of Thailand (SET) that have completed continuous financial data for the 9 years period investigated.²The method of identification of the politically connected firms is developed from past literature, including descriptive and in-depth researches of Brooker.³

1.4 Contribution

This paper examines the effect of political connections in respect of the quality of earnings information and market reaction towards earnings announcement to the firms listed on the SETO. These aspects are vital for the information on earnings is one of the most predominant information in investment decision and they have not yet been carefully explored in the study of the political connection and the benefits they give connected firms in Thailand.

² As available from www.parliament.go.th , and the SETSMART database.

³ *Thai Business Group: A Unique Guide to Who Owns What* by Brooker, and *The Fifty-Five Most Well-known Families* by Nation Multimedia group.

CHAPTER II: LITERATURE REVIEW

The literature review for this thesis is presented in three parts. The first discusses previous studies of benefits firms gain from political connection and reviews the research of this issue that has been done on Thai firms. The second part which is the focal point of this paper argues the effect political connection has on connected firms in the aspect of debt finance which includes the quality of earnings information and the cost of debt. Finally, the last part which is the additional study of the benefits of political connections in this paper discusses the effect political connection has on equity finance which is stock price by examining the market reaction to annual earnings reports of the listed firms. The event study approach used in the third part is also reviewed and discussed here.

2.1 Political connection

Political connectedness has been documented by many studies to create additional value to the connected firms. Evidences presenting the existence of political connections and the benefits they derive are profuse. The benefits of political ties were reported in different countries and perhaps with a different nature. Political connections also have different effects; a positive effect for the connected firms and negative effect on the society.

The extensive work of Mara Faccio (2006) is one good example in illustrating the thorough evidences on the benefits firms obtain from political connections are found in several countries. He used a rich database of 47 countries and pointed out that, in 2001, connections are common in countries with high degree of corruption and countries with foreign investment restriction and reported increasing stock returns of the politically connected firms. In addition, the study reported evidence of increasing stocks returns which are accounted from the connection of big business and politics.

The studies of value added from political ties have been carried out in both developed and developing countries. In United States, the works of Cooper, Gulen and Ovtchinnikov (2008) and Goldman, Rocholl and So (2006) reported similar benefits of this kind of economic rent through several accounting and market performances. Niessen, Ruenzi (2007) presented the same positive result for Germany while the evidence in France came from Bertrand, Schoar, Kramarz and Thesmar (2004). As for the evidences from developing countries, the studies have been particularly highlighted on Asia due to the trigger of the Asian Financial crisis in 1997

which was a drastic contrast to the so called East Asian miracle rapid growth in the late 1980s to early 1990s. In China, Cheung, Lau, and Stuaraitis (2008) reported that central government control firms benefit from their related party transactions with their central government state-owned enterprises. Fisman (2001) found the large portion of well-connected Indonesian firms' value might be derived from connectedness with President Suharto. Eventually, the work of Johnson and Mitton (2003) brought clear evidence that Malaysian firms which were connected with Prime Minister Mahathir Muhammad benefit more from capital control in 1998 while, at the same time, receiving higher negative returns during the time of crisis. All in all, previous researches showed that connected firms may gain benefits from easier debt financing, lower taxation and better market power as well as having an average better performance than the non-connected firms.

As we look into why is it important to study politically connected firms in Thailand, the country appears to have quite a low level of transparency and low investor protection; therefore, investors may be face greater risk. Several works have been conducted to investigate the different shape and form of the benefits of political connection in Thailand. For example, the work of Imai (2006) defined the value added benefits from connections as improved ROA and profitability ratio and examined the data during the Thaksin Shinawatra government and reported a positive and significant relation between political connectedness and the firms' performances. The later work of Bunkanwanicha and Wiwattanakantang (2008) shifted their definition of connectedness towards connection with the cabinet member and ownership of the Thai tycoon families during the same period of Imai's study. They reported that the connected firms gained higher market shares, abnormal stocks returns, and favorable public policies from their connection after the tycoon took the office in 2001. On the other hand, the study of Udomworarat (2005) examined the relationship between politics and stock returns in the SET during 1993 to 2004 and reported an average negative relation in terms of stock returns, several accounting indices and Tobins'q ratio. In addition to the Udomworarat's, Chantrataragul (2007) investigated the connection between political ties and firms listed in the SET during 2001 to 2004, gave a rather mixed conclusion of the benefits connected firms.

We could see that the literatures on the effects of political connections have been focused on the financial effects on firm. The reasons account for this may due to (1) measuring the negative effects the political ties may be more difficult and (2) several benefits such as bribe

and policy corruption are hard to capture and publish. In addition, financial effect could be considered a good indicator for the benefits that could not be investigated. This paper investigated two areas of the financial effects political connection have on firms which are the effect of debt finance and effect on equity finance.

2.2 The effect on debt finance: Earnings quality and the cost of debt

In the investigation on the financial effects political connections have on firm, we'd look into this issue in terms of the ability politically connected firms have in acquiring cheaper debt finance than their non-connected peers. One approach to determine this is to explore the relationship of among political connectedness, the quality of the firms' earnings information and their cost of debt.⁴ In summary, political connections provide protection for connected firms with lower quality of earnings so they would not get the usual penalty and allow connected companies to have lower cost of debt than the rate they would get with low quality of earnings information.

The quality of firms' earnings, which is the extent to which reported earnings reflect operating fundamentals, is not only one form of firm's performance indicator but also has been given great attention for it may have predictive power for future movements in stock prices.⁵ Reported earnings are considered primary indicator of information quality as suggested by Dechow et al. (1998). The earnings quality approach focuses on the absolute magnitude and/or the variability of accruals to assess earnings quality on a standard practice since a firm's earnings differ from cash provided from operation by the amount of reported accruals. To be more specific, most earnings quality research focuses on discretionary accruals because accruals include both discretionary and non-discretionary components and discretionary accruals are believed to better reflect manager's judgments.

In addition, managers could imply having greater magnitude of discretionary accruals that there is greater possibility of earning manipulation. Sloan (1996) suggested that firms with higher levels of accruals have lower quality of earnings as implied by his findings that the

⁴ There are several other benefits political connections have on debt finance. For preferential access to credit, there are studies by Cull and Xu (2005), Johnson and Mitton (2005), and Khwaja and Mian (2005). Beakman (1999) and Dinc (2005) investigated evidence of preferential treatment by government owned banks. Faccio et al (2006) studied the bailouts benefit granted by political ties.

⁵ Please refer to Chan et al (2006) for further information on earnings quality and stock returns.

accrual portion of earnings is less persistent than cash flow. Several studies such as Dechow et al. (1996) and Richardson et al. (2003) also indicated that managers have effects on the direction and magnitude of accruals. Several works give economic explanation for poor earnings quality on agency and governance issues. Fan and Wong (2002) find that the reported earnings of Asian family firms provide limited information, which caused by an entrenchment effect.

The analysis in this paper will examine the relation between earnings quality or the quality of accounting information and political connections which is also suggested by Chaney et al. (2009) who adopted the discretionary accruals method in estimating the firms' quality of earnings information. They suggested that, *ceteris paribus*, higher variance or absolute magnitude of unexplained discretionary accruals is associated with lower quality of earnings data. Their study showed that the quality of earnings reported by politically connected firms appears to be significantly poorer than the non-connected companies. Their paper and results are what inspired this thesis into investigating the issue of information of the politically connected firms in Thailand.

The paper by Chaney et al. (2009) also incorporated the cost of debt to further their investigation of the politically connected firms and their quality of accounting information. They argued that, in contrary to previous findings, poorer earnings quality is associated with higher cost of debt in the case for politically connected firms. They gave a rationale that political connection could benefit by using political pressure to intervene for better borrowing situation for politically connected firms. The measures Chaney et al. (2009) used to examine the cost of debt, which is the effective rate that a company pays on its current debt, are the average realized cost of total debt and the yield to maturity spread on publicly issued debt. Our paper also chose to follow this paper and employed the cost of debt into our study as well.

2.3 Effect on equity: Earnings quality and market reaction towards earnings announcements

There have been several researches that studied the effect political connections have on equity. Many of them investigate whether political connections have direct effect on the stock returns. For example, the work of Faccio (2006) reported that political connectedness help improving the connected firms' stock returns.

However, there have been several studies that investigate the quality of earnings information with stock returns and reported that poor quality of earnings or high accruals is negatively related to stock returns. The study by Sloan (1996) reported that stock with larger accruals in given year tend to have low returns in subsequent years because high accruals signifies that earnings are high relative to cash flows. This finding was confirmed by the research by Collin and Hibar (2003) by using quarterly accruals information. Moreover, the work by Chan et al. (2006) also suggested negative association between accruals and the future stock returns.

The study of Rajgopal and Venkatachalam (2008) has demonstrated that the quality of reported earnings as well as disclosure improvement decrease information asymmetry about a firm's performance as well as reduces the volatility of the stock price. We could conclude from this that the quality of earnings information has negative association with stock price shock, which in turns has negative relation on the stock price's stability. On other words, the quality of earnings has an indirect effect on stock price. Another similar work with concurrent results as Rajopal and Venkatachalam's is the research by Easley and O'Hara (2004), which suggested that financial reporting quality could influence the firm's information risk, its idiosyncratic volatility, and its cost of capital.

Since the area that study the relationship between the quality of earnings and the stock returns as well as the association between political connections and stock returns have been exhaustively researched and the results reports have been concurrent. Rajgopal and Venkatachalam (2008) used the usual variance method to study association of the volatility of the stock price which they focused on the idiosyncratic return volatility and earnings quality but such method would be plausible to be a study of its own. Therefore, this paper proposed to study the indirect effect of the political connection and earnings quality information have on the shocks in share price by looking at the market reaction toward an event of annual earnings announcement. In order to simplify the observation of the investors' reaction toward earnings announcement, we applied financial method of event study.

The event study as one of the most frequent used methods in the financial research enables an observer to assess the impact of a particular event on a firms or several firms' stock price. If the market were efficient, the security prices would instantaneously reflect all currently available information in the market. The price changes would then reflect new information.

The unexpected returns which occur as a result from an event could be calculated using index model or estimated the average returns around the date the information of the stock is released. The event study of political connection and firms has been condensed on political events, for instance, political elections or holding office period. Works of Brown et al. (1998), Fisman (2001), and Johnson and Mitton (2003) are apparent examples for this particular kind of study. The event for our study is the announcement of the firms' annual earnings announcement which is required for the entire listed firms in the stock exchange of Thailand.

Broadly speaking, within a single index model, the stock returns are determined by firm specific factor and a market factor. The stock returns could be calculated using:

$$R_{it} = \alpha_i + \beta_i R_{mt} + u_{it} \quad (1)$$

Where R_{it} is the stock returns, R_{mt} equals the market rate of returns during the period, u_{it} is the part of security returns from firm specific events. The parameter β_i measures the sensitivity to the market returns and α_i defines the average rate of return the stock would realize in a non-profit or zero market period. Consequently, the firm specific return in a given period could be estimated by:

$$u_{it} = R_{it} - (\alpha_i + \beta_i R_{mt}) \quad (2)$$

Given the stock's sensitivity to the market, the residual or the u_{it} would defy the stock's return that is not only be determined by the market movement alone. In other word, the u_{it} is referred as the abnormal return. However, in order to avoid leakage of information problem that may arise when information is released among a small group of investor before being released to public, we'd use cumulative abnormal return instead. The cumulative abnormal return defined as the sum of abnormal returns over the time period of study, captures the total firm specific movement of the stock throughout the whole period of study and allows us to fully observe the market reaction to the specific event as well as the entire period we study.

The normal steps in conducting an event study include (1) identifying the announcement or event (2) collecting a sample of firms making the same announcements, the announcement date and the prices surrounding the announcement date (3) rearranging the return data from calendar

to event date (day zero) for each stock (4) calculate the abnormal and cumulative abnormal returns in order to determine market reaction. Here we'd focus on looking at the pattern or the speed of adjustment the market adjust price to reflect new information and compare between the connected and non-connected firms.

In conclusion, the variables this study will research are the quality of earnings information, the cost of debt and earnings announcement of the politically connected and non-connected firms that were listed on the Stock Exchange of Thailand during 2000-2008. Consequently the propositions this paper makes regarding the research questions are (1) do political connections grant benefits for firms in Thailand? (2) as noted the quality of earnings has inverse relation to the cost of debt, do connections have negative effect on the quality of earnings information and positive effect on the cost of debt.

Work of Chaney et al. (2009) suggested that political connections could have negative effect on the quality of earnings information. In other word, political connectedness allows firms to produce poorer quality of earnings information reports with the financial incentive to save cost. Therefore, connection is inversely related to the quality of earnings information estimated by accruals and is likely to have indirect effect on the cost of debt. That is, *ceteris paribus*, lower quality of earnings caused by political connection would likely to increase the cost of debt. Connection, thus, could have negative effect on the cost of debt. By political ties allowing connected firms to obtain debt finance at lower cost, we could consider them to enhance firms' financial benefits.

In conclusion, previous studies of the benefits firms gain from political connection in Thailand have been focused on stock price and performance indicators such as ROA and Tobin q ratio. The finding on whether firms in Thailand have experienced financial benefits remains inconclusive and is difficult to be verified due to the different period of study in the researches. Consequently, this thesis aims to use the unconventional approaches which are the quality of earnings information, the cost of debt and the market reaction to fill the gap of the previous literatures.

CHAPTER III: METHODOLOGY

This section represents the methodology of this thesis by firstly explains the sample of the data and the source from which the data used in the study are derived from. Secondly, the research hypotheses which are divided into 5 hypotheses discuss the questions of the thesis and their rationale in detail. The last part, methodology, is the most important part of this section. It illustrates the approaches used to answer the research questions or the research hypotheses as well as fully explains the calculation or the derivation of the political connection, the quality of earnings information, the cost of debt and the market reaction towards earnings announcement.

3.1 Sample and source of data

The total samples are the firms listed on the Stock Exchange of Thailand (SET) during 2000-2008 excluded firms with unavailable data and firms that were marked in rehabilitation or had negative equity.

The sources of the data are divided into two groups. First is the politically connected firms' data which is composed of the data on politician and connection. The politicians' data which are the name and the period the politicians, both the members of the House of Representatives and cabinet members, were in office are obtained from www.cabinet.thaigov.go.th and www.parliament.go.th. The data on the connection are based on the secondary analysis of the books; mainly, Brooker group's "A Unique Guide to Who Owns What" and "The Fifty-Five Most Well-Known Families" and the information of the particular stock on www.settrade.com and the *SETSMART* database. Further secondary material used in the research and data building of political connection could be seen in the Bibliography at the end of this paper.

Secondly, most of the data for the investigations of the quality of accounting information, the cost of debt and the market reaction towards earnings announcements are derived from *DataStream*. All the accounting data for the earnings quality testing are obtained from *DataStream*, namely; the annual information of current assets, current liabilities, cash, short-term and long-term debt, assets, sales, and operating income after tax of the firms listed on the SET during 2000-2008.

The required data for the event study of market reaction toward earnings announcement are the earnings announcement dates, defined as the day Securities and Exchange Commission (SEC)

receive the annual financial statements from the company which are derived from www.sec.or.th, the risk free rate, using the interbank borrowing rate provided by the Bank of Thailand (BOT)⁶ and the returns, both each firms' daily returns and the return index⁷ provided by *DataStream*.

3.2 Research Hypotheses

From our analysis of the literature in the area aforementioned, several hypotheses with regard to our research question can be deduced. Firstly, political connectedness has negative effect on the quality of earnings information. The connections allow firms to produce lower quality reports with safe cost or without the usual penalty. Therefore, our first hypothesis is as follows:

Hypothesis 1 Politically connection causes firms to have lower quality of accounting information. Therefore, politically connected firms will have higher discretionary accruals than non-connected firms.

Chaney et al. (2009) suggested that the connected firms, which have higher degree of political involvement, are expected to have lower quality of earnings reported or have a higher absolute amount of standard deviation of the discretionary accruals as captured by performance-adjusted current accruals measure (REDCA). This paper will compare the negative effect politically connected firms have on the quality of accounting information as measured by applying discretionary accruals method to find the different between the expected and the actual accruals and compare it between connected and non-connected firms. We then will run an ordinary least square (OLS) regression between the quality of earnings information proxy, the political connections dummy variables and other control variables that may have effect on the quality of earnings as suggested by preceding literature in this area.

We separate the connected group into two types in order to investigate whether the different in means of connection will have a positive or negative effect on the cause of debt. Firstly, a firm is considered to be connected through shareholding if it has at least 10 percent of the

⁶ The interbank rates are used instead of the monthly T-bill due to the lack of data availability. However, the interbank rates were found to have very high covariance with the monthly T-bill rates.

⁷ The SET500 returns index during 2000-2002 is not available; hence the price index is used instead during the period. Using the price index may slightly underestimate the returns of the SET index because the dividends are omitted instead of being added back.

shareholding in the firm held by a politician. We will here after refer the group as SH. The means of connection of the second group is connection through having at least two members of the board of directors or board of management being politically connected. The latter group is named BM. In order to investigate the effect SH and BM have on the quality of accounting earnings, our second hypothesis is conducted as follow:

Hypothesis 2 Politically connections through shareholding (SH) and through board of management (BM) both cause firms to have lower quality of accounting information. The two different means of connection are likely to affect the quality of accounting information to a different extent. Therefore, the magnitude of discretionary accruals of politically connected firms through SH will not be equal to that of politically connected firms through BM.

Thirdly, when a firm has poor quality of earnings they would be penalized, for instance, facing higher cost of capital, getting more frequent enforcement actions by the SEC or having poor future returns. With political connections, connected firms have their punitive deterred. Generally, the higher the cost of debt a firm has, the more risky it would be observed by investors. This paper will use the cost of debt as substitute of the penalty lower quality of earnings information and investigate the relationship between political connections and cost of debt. As previous literatures suggested evidences of the association of the cost of debt and political connectedness, our second hypothesis is as follows:

Hypothesis 3 Politically connection causes firms to have lower cost of debt. Therefore, politically connected firms will have lower average cost of debt than non-connected firms.

The cost of debt is a measure indicating the overall rate being paid by a firm to use debt financing. We first estimate the cost of debt as the ratio of the debt incurred over the total debt obligation and compare the univariate results between the politically connected and non-connected firms. Secondly, we will run regression (OLS) analysis using the cost of debt as dependent variable and the political connectedness dummy, the proxy for the quality of earnings, and other firm specific variables suggested by previous studies on the cost of debt.

Similarly to the rationale used for our second hypothesis, in order to compare between the different effect on the cost of debt cause by two distinct means of political connection, we proposed the forth hypothesis as follows:

Hypothesis 4 Politically connections through shareholding (SH) and through board of management (BM) both cause firms to have lower cost of debt. The two different means of connection are likely to affect the cost of debt to a different extent. Therefore, the magnitude of the cost of debt of politically connected firms through SH will not be equal to that of politically connected firms through BM.

Univariate statistics of the cost of debt of the group SH and BM will be present along with the regression results between the political variables (SH and BM), the dependent variable cost of debt and other control variables. Finally, previous researches suggested the quality of earnings information has a negative effect on the stock price shock, which would then affect the share price and the firm's cost of equity respectively. We will conduct an investigation on the stock price shock by using the method of event study and, thus, our last hypothesis is as follows:

Hypothesis 5 Political connections will lead to fewer shocks in stock prices. Therefore, there will be lower volatility of stock prices of politically connected than that of non-connected firms in response to earning announcements.

Assuming that the market is efficient, the reaction displayed by returns toward the yearly earnings announcement of the connected and non-connected companies should be the same. To be more specific, we will observe the cumulative abnormal return of the connected firms around the annual earnings announcement of the firms listed on the SET during 2000-2008 that will form into patterns. As the quality of earnings are expected to be lower for connected firms and this information might be incorporated by investors, this would allow us to expect that the connected firms will have less sharper pattern of market reaction and less earnings surprises in comparison to the non-connected firms. It is very important to note here that in the case of event study on reaction towards earnings, we need to separate the good news and bad news in order to compare between the politically connected and non-connected firms.

3.3 Methodology

3.3.1 Definition and identification of politically connected firms

A firm is considered politically connected if it is connected to a politician who is in office for a minimum period of six months in the year investigated. The politician as mentioned in the data section includes both the representative and the cabinet members who were taking office in the period of study, 2000-2008. The connection is recognized among the surnames of the politicians and the families of business groups in Thailand.⁸ The families will be defined as politically connected if their relationship with the politician is considered to be in the following conditions⁹:

- i. A politician is a member of a particular family or the relationship between the politician and family is by blood lineage.
- ii. A family has in-law relationship with a politician in which the relationship is established through the marriage between the two groups.
- iii. A family member is known to have a close relationship with the politician or the politician's relative.
- iv. A family member has a joint business with a politician in which the particular business is co-owned and is a flagship of the family's businesses

The procedures to identify politically connected firms are consisted of three main steps. The first is to collect the surnames of the politicians and the families required in the period of study and the data on connection findings as have been mentioned. In addition, the data on private holding company of the top families is also gathered using the Brooker Group's report (2003) in order to enlarge the set of the listed firms' shares hold by each family; particularly in case that the family does not directly hold the firms but have the juristic person as owner.

The Second is to match the data from the first step with data of major shareholding and the board of management of the listed firms, which were obtained through *SETSMART* database. In terms of the shareholding, the percentage of the shares held by the person considered to be politically connected will be summarized for each year and firm. The break points of the

⁸ The matching between surnames is applicable in Thailand case because of the length and uniqueness of the Thai surnames.

⁹ The process was introduced by Suppapolsiri (2009) and was based on the books: Brooker group's "A Unique Guide to Who Owns What" and "The Fifty-Five Most Well-Known Families". The detailed process could be observed in Appendix A.

percentage of the shareholding are set at 10 percent. As for the board of management, the surname of a board of management of the listed firm will also be matched with the surname of the politicians and the families. The number of the politically connected board of management will also be summarized for each year and firm and have two politically connected managers. A firm is considered to be politically connected through board of management if the politician is connected to the firm through the four types of relationship as depicted in i to iv and have a similar surname to two or more board member of the firm.

In conclusion, the firm will be considered politically connected in two perspectives. First is by having large amount of shareholding, the politician who is connected to the firm in the conditions mentioned above having large amount of shareholding of 10% or more of the firm.¹⁰ Second is by board of management that is if two or more of the board member are connected with the politician then it is considered politically connected. Consequently, the politically connected firms are divided into three types namely connecting through share holding group (SH), connecting through board of management group (BM) and finally the group connecting through both categories (SHBM).

For example, in 2003 TTL's shareholding by surname Adireksan which is similar to the representative who was in office during 2003 equals 2.68 percent. Thus, TTL is not considered a political connected firm in terms of connecting through shareholding and not verified as SH. However, 4 out of 21 of the board member have similar surnames with the list of the politicians holding office in 2003, we then consider TTL as connected firms in terms of connecting through board of management. Hence, TTL is verified as NON-SH, BM and SHBM.

3.3.2 Testing the quality of accounting information

Calculating quality of earnings information by using REDCA

As we mentioned in the introduction that reported earnings especially in the discretionary part is considered as an important indicator of information quality. The discretionary accruals could be calculated as the unexplained residual error estimated from a benchmark model of accounting accruals (Chaney et al. (2009) and a higher variance or absolute magnitude of

¹⁰ As have been set as percentage breaking point in Imai (2006), Bunkanwanicha et al.(2008) and Faccio(2006).

unexplained accrual is *ceteris paribus* associated with lower quality of earnings data as suggested by Hibar and Nichols (2007).

The discretionary accruals as this paper's main measurement of quality of accounting information could be calculated using a performance-adjusted current accruals measure (REDCA). The higher the REDCA, the lower the quality of the earnings data will be. I replicate the work of Chaney et al. (2009), which apply the similar method used in Ashbaugh et al. (2003). The REDCA is computed as the difference between total current accruals (*TCA*) and expected total current accruals (*EPTCA*) as could be observed in the following equation:

$$REDCA_{it} = |TCA_{it} - EPTCA_{it}| \quad (3)$$

TCA or the total current accruals could be computed from the following equation:

$$TCA_{it} = \frac{\Delta(\text{Current Assets})_{it} - \Delta(\text{Current Liabilities})_{it} - \Delta(\text{Cash})_{it} + \Delta(\text{Short term \& Current-long term Debt})_{it}}{Assets_{it-1}} \quad (4)$$

Where Δ is the first difference (with respect to time) operator and Current Assets (WC02201) equal to the sum of cash and equivalents, receivables, inventories, prepaid expenses and other current assets. The Current Liabilities (WC03101) is composed of debt or other obligations that the company expects to satisfy within one year where as the Cash (WC02001) equals to the sum of cash and short-term investments. The Short Term and Current Long Term Debt (WC03051) is the portion of financial debt payable within one year including current portion of long-term debt and sinking fund requirements of preferred stock or debentures and the Assets (WC02999) equals to total assets. The subscript *i* refers to the firm while *t* refers to year.

To estimate the expected performance-adjusted total current accruals (*EPTCA*), we estimate the following equation:

$$TCA_{it} = \alpha_j \frac{1}{Assets_{it-1}} + \beta_j \frac{\Delta \text{net sales}_{it}}{Assets_{it-1}} + \gamma_j ROA_{it-1} + \varepsilon_{it} \quad (5)$$

Where, Sales (WC01001) are defined as gross sales and other operating revenue less discounts returns and allowances. Lagged ROA, the operating income after taxes (WC08326) relative to

total assets is included to control for firm performance.¹¹ This model estimates the pooling data of accounting data required by the SET during 2000-2008. The parameters achieved from equation (5) will be used to estimate the EPTCA in the following equation (6):

$$EPTCA_{it} = \hat{\alpha} \frac{1}{Assets_{it-1}} + \hat{\beta}_j \frac{(\Delta net\ sales - \Delta AR)}{Assets_{it}} + \hat{\gamma} ROA_{it-1} \quad (6)$$

Where ΔAR denotes the change in account receivables and all other variables are similar as defined earlier. The REDCA in equation (3), which is the measurement of the quality of accounting information of our sample, will be compute during 2004-2008 (REDCA_5yrs) and 2000-2008 (REDCA_9yrs). The reason why REDCA is separated into short (5 years) and long (9 years) periods is suggested by Francis et al (2004) and Francis et al. (2005) in order to solve the survivor bias problem that may arise in the results. Finally, we calculate the standard deviation of the REDCA for each firm in each year.

Control variables

The firm characteristics control variables for the regression analysis of the REDCA, which are included as suggested by prior studies associated with the quality of accounting information¹² as applied in Chaney et al. (2009), are *Control*, *Operating Cycle*, *Size*, *Operating volatility measures*, *Market-to-book* and *Leverage*. The ownership data used for Control are taken from the data base co-developed with Subdanai Supapolsiri composed of qualitative study of the political connection from sources mention in the first section and www.settrade.com while the other variables are computed using accounting data derived from *Datastream* as measured of 2004. By fixing the independent variables as of 2004, this paper is making an assumption to fix independence and erogeneity problem.¹³ Due to the fact that the periods of study are during 2004-2008 and 2000-2008, 2004 seems to be a plausible choice. However, fixing others year of the study did not result in much change in our findings.

Control is the size of the voting stake held by the largest ultimate shareholder. According to La Porta et al. (1999), investor could gain control in a company directly by shareholding or

¹¹ This was suggested by the research by Kothari et al. (2002).

¹² Examples of the study include the work by Fan and Wong (2002), Luez et al. (2003), and Leuz (2006).

¹³ In Chaney et al. (2009) the year fixed is 2001 and the authors believe fixing a year makes the assumption of independence and erogeneity more plausible given their variables are measured over 2001-2005.

indirectly through holding companies or other firm. In the direct case, the investor will be entitled to express the fraction of votes accordingly to the shares he owns. As for the indirect case, the investor's share of control right will be measured by the weakest control link along the pyramid. *Family* is also defined as dummy variable set equal to 1 if the largest shareholder is a family or individual controlling at least 20% of the votes and 0 otherwise.

Operating Cycle is defined as log of sum of days in receivable (WC08131) and days in inventory (WC08123). The inclusion of this variable was suggested by the work of Francis, Lafond, Olsson and Schipper (2004) as was also applied in Chaney et al. (2009). The next control variable is *Size* or *Ln Mkt Cap* measured as natural log of company's market capitalization (WC07210).

Operating volatility measures are introduced as control variables for the accruals regression as Hribar and Nichols (2007) and Liu and Wysocki (2007) suggest that measures of accruals quality are likely to be biased if they are not controlled by operating volatility measures. The first operating volatility used is the volatility of cash flow over total assets, $\sigma(\text{CFO}/\text{TA})$ or SD of CFO/TA during the periods of study which are 2004-2008 and 2000-2008. The Cash flow (CFO) is defined as:

$$CFO_{it} = \text{Income before extra items} - TCA_{it} + \text{Depreciation and Amortization}_{it} \quad (7)$$

Where *Income before extra items*_{it} is defined as income before extraordinary items and preferred and common dividends, but after operating and non-operating income and expense, reserves, income taxes, minority interest and equity in earnings (WC01551); $TCA_{it} = \Delta(\text{CurrentAssets})_{it} - \Delta(\text{CurrentLiabilities})_{it} - \Delta(\text{Cash})_{it} + \Delta(\text{Short-term and Current, long-termDebt})_{it}$; *Depreciation and Amortization*_{it} is the sum of depreciation, depletion and amortization expenses (WC01151). TA is total assets which is the sum of total current assets, long term receivables, investment unconsolidated subsidiaries, other investments, net property plant and equipment and other assets (WC02999). The second operating volatility measure is the volatility of sales over total assets, $\sigma(\text{Sales}/\text{TA})$ or SD of Sales/TA, during 2004-2008 and 2000-2008. Finally, we control for the yearly growth of sales (WC08631) measured as of 2004, *Sale Growth*, and the standard deviation of the annual growth of sales, $\sigma(\text{Sales Growth})$, during 2004-2008 and 2000-2008.

Market-to-book is also controlled in the regression. It is defined as the ratio of market capitalization to book value of equity. Finally, *Leverage*, defined as total debt as percentage of total assets (WC08236), is also added as independent control variable.

Apart from these control variables, the *political connection* is also set as an independent variable. Since the political connection are separated into three groups in this study, the *connected firms* is also defined as dummy variable set equal to 1 if the firm is connected through shareholding (SH) and 0 otherwise. Similarly, the firms connecting through board of management (BM) will have dummy variable set equal to 1 and 0 otherwise. As well as the group that is set to be political connected through shareholding or board of management (SHBM) will have its dummy variable set equal to 1 and 0 otherwise.

After the REDCA is calculated, the anomalies or extreme value will be eliminated using winsorizing method. To winsorize is to transform extreme value in the statistical data. It is similar to trimming, which is removing the extreme values. Instead of simply excluding the extreme data, winsorizing replaces the data by certain percentile. In this paper, we use 90 percent winsorize which means replacing the bottom 5 percent data with the 5th percentile data and the top 5 percent data with the 95th percentile data. By using this method, we will have lesser number of data excluded than trimming.

3.3.3 The Cost of Debt

Calculating the Cost of Debt

The cost of debt is the effective rate that firm pays on its current loans, bonds and various other forms of debt. It indicates the overall rate being used for debt financing and gives an approximate idea to the investors how risky a company can be. This financial indicator could be simply measured as the ratio of the debt the firm incurred over its total debt obligation. It could be calculated through several approaches, however, this paper follows Chaney et al. (2009) who adopted Francis et al. (2005) and Liu and Wysocki (2005) and calculate the cost of debt as the ratio of the interest expense over the total debt. In other word, the cost of debt is measured as a firm's interest expense in year t (WC01251) over the interest bearing obligations outstanding between fourth quarter of year t-1 and fourth quarter of year t or the total debt

(WC03255A). The calculated average cost of debt will also be winsorize in order to eliminate extreme values.

Control variables

The control variables for the cost of debt ordinary least square regression are quite similar with the ones used in the REDCA regression. The exception is that Control or Ownership data and operating cycle are not needed in this case. In addition, *interest coverage ratio*, which is calculated by operating income (WC01250) over interest expense (WC01075) during 2004, is added as control variables.

3.3.4 Event study of the market reaction towards earnings announcement

The reaction of the market on earning announcement could be observed through the abnormal returns, which represent the result of new information at time of the announcement. The firms are divided into two groups - political connected firms and ordinary firms. As for the measurement of abnormal returns, the standard event-study methods¹⁴ are applied to examine the stock price responses to earning announcements. Day 0 ($t = 0$) in event time is defined as the date of announcement of the firms' annual financial statement which was collected from the SEC website and was the same date as reported on the SET. The event window is 80 days around the event date, 59 days before the event date and 20 days after ($t = -59$ to $t = 5$). The CAPM beta will be estimated for each stock through the following equation:

$$R_{it} = \alpha_i + \beta_i R_{mt} + u_{it} \quad (8)$$

Where R_{it} is the expected returns and R_{mt} is the real returns, the excess returns are then calculated using the raw excess return method displayed in the following equation:

$$AR_{it} = R_{it} - R_{mt} \quad (9)$$

¹⁴ See Dodd and Warner (1983) for detailed description of event-study methods and statistic tests.

After averaging the abnormal returns across all firms, the statistical significance is tested using the t-statistic. The similar steps are applied to both the ordinary firms and political connected firms to see whether the investors react in the same way toward the firms' earnings announcement. However, as investors have been focused on the profits of the firms or the earning itself, the reaction toward good news, the positive earnings and the bad news, negative earnings must be filtered out of the market reaction. This could be done through matching the good and bad news to the two groups of firms. If both the good and bad news of the politically connected firms yield similar market reaction, we could infer that the quality of earnings does not reflect the firms' stock prices.

CHAPTER IV: RESULTS

This Chapter provides the results from the models demonstrated in the preceding chapter which analyze the listed firms' political connection with the polity, the performance of the connected firms in term of their quality of earnings information, cost of debt and the market reaction toward the annual earnings announcement.

The data of the listed companies on the Stock Exchange of Thailand (SET) during 2000 to 2008 were gathered excluding the firms whose data were unavailable and those which were delisted or were in rehabilitation. The total sample of this study equals 2689 firms and these selected firms then were checked whether they are politically connected through the criteria given in the previous chapter.

4.1 Political Connection

4.1.1 Percentage of politically connected firm

The first table, **Table 1**, consists of the number of the total number of firms in the study throughout the study period of 2000 – 2008 and the number of the sample as the firms were registered to be under rehabilitation and those with unavailable data were excluded. The connected firms are divided into three groups as discussed in the methodology namely group connecting through shareholding (SH), group connecting through board of management (BM), and group connecting through shareholding or board of management (SHBM). These selected samples are used to examine the relationship between political connection and firm benefits in terms of its quality of earnings information and the market reaction toward earnings announcements.

After matching the accounting data from *Datastream* with the data on political connection described in section 3, the final sample includes 2689 firms which are listed on the SET in the 9 years period of study. From the table, the firms politically connected through board and management (BM) are significantly higher than the firms connected through shareholding (SH). The percentage of connected firms through shareholding appears to be highest in 2002,

2003 and 2006 while the percentage of connected firms through board and management is highest during 2001, 2002 and 2004.

4.1.2 Descriptive statistics of firm characteristics

The characteristics of the connected and non-connected firms during 2000 to 2008 are depicted in **Table 2**. The totals of 2689 samples are firms listed on the Stock Exchange of Thailand (SET) and are divided into connected and non-connected firms. The SH group is the politically connected firms of which the connection is through having at least 10% share held by a politician who is holding position at the time and the NON-SH is the rest of the firms or the non-connected firms in this category. Similarly, BM equals the connected group of firms through having the same surname between at least two board of management members and a politician while NON-BM applies for the non-connecting firms in this category. SHBM is a group in which its connected firms are connected through either or of the former categories. The mean and median of the firms' characteristics are illustrated here to separately display between the connected and non-connected groups.

The data of the characteristics are derived through *Data Stream* excepted for the ownership concentration which is gathered using information from the SETSMART database, the SET and the SEC website, and secondary text books regarding business owners in Thailand. *Size* is measured as the ln of the firm's market capitalization while *Leverage* is the percentage of total debt over total assets and *DE Ratio* is the debt to equity ratio defined as the firm's total liabilities divided by total assets. *Total assets* is the book value of firm's assets at the end of year, *Total Debt* is defined as the book value of firm's liabilities at the end of year and *Market CAP* is the firm's total market capitalization at the end of year in million Bath. *Ownership* is the size of voting stake held by the largest ultimate shareholder in the firm.

The average size of the firms connected through shareholding (SH) is slightly bigger than the non-connected firms in their category and the average size of the total samples. In contrary, both BM and SHBM are smaller in size when comparing to the non-connect firms in their groups. In terms of leverage, the connected firms in all categories have higher average leverage than the non-connected firms and the overall sample. Firms that are politically connected through board of management, BM, have the highest leverage at 31 percent and result in having the highest gap from the non-connected firms in their group which have 20 percent

leverage. However, the debt to equity ratio results differently. All the connected firms group have smaller de ratio with SH group have slightly smaller de ratio comparing to NON-SH.

As for the average total assets and total debt, it does not come as a surprise that all the connected firms are smaller than the non-connected firms. This is because the connected firms are significantly smaller in numbers. However, the average market CAP of the connected and non-connected firms in all 3 groups appears to be very close. Finally, the percentage of ownership of the connected firms shows a very clear result of all the connected firms having higher ownership concentration compared to the non-connected firms. The SH group in particular has 38.12 percent of average ownership.

Table 3 displays the industrial characteristic of the politically connected and non-connected firms as defined by the SEC. The connected groups are connecting through shareholding then the group is defined SH, connecting through board and management, BM and connecting either of the two, SHBM. The table shows that politically connected firms are present in 19 industries. For the first group, SH, the connected firms are most concentrated in Assets and mutual funds, Transportation and Logistics, and Information Technology and Communication respectively. In the second group, connecting through board of management, Traveling is most concentrated with politically connected firms followed by Industrial Material and Machinery, and Transportation and Logistics. The final group, SHBM, shows that connected firms are found most in Assets and mutual funds, Food and Beverage, and traveling respectively.

Table 1 Number and percentage of politically connected firms

A company is considered connected with a politician in term of shareholding (SH) if one of the company's or holding company's major shareholders (1) have similar family name with the politician as defined as member of representative or member of cabinet, prime Minister, minister or deputy minister,(2) have any one of connection relationship as defined in number I-IV in the methodology section, (3) have 10% or more shareholding of the firm. Similarly a company is considered connected through board and management (BM) if at least two board and management member of the listed firm is closely related that is have any one of I-IV connection condition or have the same family name as a politician as defined as representative or member of cabinet. The total sample are listed companies on the Stock exchange of Thailand excluded rehabilitation and unavailable data. The period of study is consisted of several governments since Taksin Sinnawatra (2001-2006), General Suryuth Julanont (2006-2008), Samak Sundornraverj (2008), Somchai Wonsawasdee (2008) and Chwarath Chanveerakul (2008). The total sample are divided into three groups: group connecting through shareholding (SH), group connecting through board of management (BM) , group connecting through shareholding or board of management (SHBM).

Year	Firms	Data	Sample	SH		BM		SHBM	
				no.	%	no.	%	no.	%
2000	373	197	176	3	1.70	11	6.25	12	6.82
2001	377	127	250	9	3.60	27	10.80	32	12.80
2002	399	137	262	10	3.82	26	9.92	32	12.21
2003	401	108	293	8	2.73	23	7.85	26	8.87
2004	412	81	331	12	3.63	27	8.16	32	9.67
2005	468	118	350	11	3.14	22	6.29	27	7.71
2006	476	119	357	16	4.48	23	6.44	28	7.84
2007	475	114	361	2	0.55	2	0.55	3	0.83
2008	476	167	309	8	2.59	17	5.50	21	6.80
			2689	79	2.94	178	6.62	213	7.92

Table 2 Descriptive statistics of firm characteristics

This table presents summary statistics of firms included in the study. The total of 2689 samples is firms listed on the Stock Exchange of Thailand (SET) and are divided into connected and non-connected firms. The SH group is the politically connected firms of which the connection is through having at least 10% share held by a politician who is holding position at the time and the NON-SH is the rest of the firms or the non-connected firms in this category. Similarly, BM equals the connected group of firms through having the same surname between at least two board of management members and a politician while NON-BM applies for the non-connecting firms in this category. SHBM is a group in which its connected firms are connected through either or of the former categories. The mean and median of the firm characteristics are illustrated here to separately display between the connected and non-connected groups. The data is of the characteristics are derived through Data Stream excepted for the ownership concentration which are gathered using Information from the SETSMART database, the SET and the SEC website, and secondary text books regarding business owners in Thailand. Size is measured as the ln of the firm's market capitalization while Leverage is the percentage of total debt over total assets and DE Ratio is the debt to equity ratio defined as the firm's total liabilities divided by total assets. Total assets is the book value of firm's assets at the end of year, Total Debt is defined as the book value of firm's liabilities at the end of year and Market CAP is the firm's total market capitalization at the end of year in million Bath. Ownership is the size of voting stake held by the largest ultimate shareholder in the firm.

	All firms		SH		NON-SH		BM		NON-BM		SHBM		NON-SHBM	
	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean
Size	13.77	12.09	13.97	13.19	13.77	12.05	13.56	11.63	13.80	12.12	13.64	11.89	13.79	12.10
Leverage	0.21	0.27	0.26	0.28	0.21	0.21	0.26	0.31	0.20	0.20	0.23	0.29	0.20	0.20
DE Ratio	0.82	1.82	0.67	1.59	0.82	1.83	0.54	0.04	0.84	1.95	0.60	0.48	0.84	1.94
Total Assets (mn Bt)	2.06	21.09	1.82	3.84	2.08	21.63	1.65	5.03	2.10	22.24	1.85	5.06	2.10	22.49
Total Debt (mn Bt)	0.34	3.64	0.26	1.17	0.34	3.71	0.18	0.18	0.36	3.78	0.21	1.72	0.36	3.80
Market CAP (mn Bt)	0.96	7.67	1.16	7.10	0.95	7.69	0.77	5.09	0.98	7.85	0.84	4.99	0.98	7.90
Ownership (%)	27.41	29.65	34.00	38.12	26.72	29.36	30.58	31.55	26.76	29.51	30.29	31.80	26.66	29.45

Table 3 Industry types of the politically connected firms

The politically connected and non-connected firms are presented here in their industrial characteristic as defined by the SEC. The connected groups are divided into three groups due to their mean of connection characteristics which are connecting through shareholding then the group is defined SH, connecting through board and management, BM and connecting either of the two, SHBM.

No	Industry Types	SH	Total	Percentage	BM	Total	Percentage	SHBM	Total	Percentage
1	Paper and Printing	0	13	0.00%	0	13	0.00%	0	13	0.00%
2	Traveling	0	107	0.00%	15	107	14.02%	15	107	14.02%
3	Medical	0	99	0.00%	6	99	6.06%	6	99	6.06%
4	Transportation and Logistics	11	123	8.94%	13	123	10.57%	15	123	12.20%
5	Home and Office Product	1	87	1.15%	2	87	2.30%	2	87	2.30%
6	Personal and medical supplies	0	36	0.00%	0	36	0.00%	0	36	0.00%
7	Asset and Mutual Funds	2	7	28.57%	0	7	0.00%	2	7	28.57%
8	IT and Communication	15	179	8.38%	12	179	6.70%	22	179	12.29%
9	Banking	-	-	-	-	-	-	-	-	-
10	Agriculture	0	160	0.00%	5	160	3.13%	5	160	3.13%
11	Medium sized enterprise	-	-	-	-	-	-	-	-	-
12	Packaging	6	103	5.83%	6	103	5.83%	11	103	10.68%
13	Specialty Services	0	16	0.00%	1	16	6.25%	1	16	6.25%
14	Insurance	-	-	-	-	-	-	-	-	-
15	Property Development	6	272	2.21%	15	272	5.51%	16	272	5.88%
16	Commerce	1	91	1.10%	8	91	8.79%	8	91	8.79%
17	Fashion	0	207	0.00%	8	207	3.86%	8	207	3.86%
18	Automotive	0	141	0.00%	5	141	3.55%	5	141	3.55%
19	Construction materials	13	180	7.22%	18	180	10.00%	22	180	12.22%
20	Media and Publishing	10	174	5.75%	11	174	6.32%	14	174	8.05%
21	Investment Unit	0	3	0.00%	0	3	0.00%	0	3	0.00%
22	Mining	0	26	0.00%	0	26	0.00%	0	26	0.00%
23	Food and Beverage	12	177	6.78%	17	177	9.60%	25	177	14.12%
24	Electronics Components	0	73	0.00%	0	73	0.00%	0	73	0.00%
25	Energy and Utility	0	161	0.00%	17	161	10.56%	17	161	10.56%
26	Steel	1	110	0.91%	6	110	5.45%	6	110	5.45%
27	Industrial Material and Machinery	1	53	1.89%	6	53	11.32%	6	53	11.32%
28	Petrochemicals and Chemicals	0	91	0.00%	7	91	7.69%	7	91	7.69%

4.2 The Quality of Accounting Information

The performance-adjusted current accruals measure (REDCA) is one approach used in evaluating the quality of the accounting information, which in this case is the annual earnings report. The standard deviations of the firm's discretionary accruals REDCA which was estimated from equation (3) and computed over 2000-2004 and 2000-2008 is used to compare the quality of earnings information among the connected and non-connected firms.

Table 4 depicts the association between REDCA and political connections that is divided into three groups. All else being held equal, the higher the value of the standard deviation of REDCA indicates lower earnings quality. In the first set of columns displays the 5-year standard deviation of discretionary accruals estimated in equation 1 and the second set of column shows the same data for the 9-year standard deviation of discretionary accruals.

Each set of rows represent statistics of the connected and non-connected firms' characteristics. For instance, there are 49 firms connected through shareholding (SH) which have their mean value of 5-year standard deviation of REDCA of 7.62 and 1645 firms which are NON-SH and have their mean value of 5-year standard deviation of REDCA equals to 11.41. The different between these means is statistically significant.

In conclusion, the overall result suggests that discretionary accruals for all groups of the connected and non-connected firms are different. It could be implied for the result in the table that the connected firms in all three groups; connecting through shareholding, connecting through board and management and connecting though shareholding or board and management, have higher mean of the standard deviation of REDCA than the non-connected firms in their category. The conclusion in this section contradicts the findings reported by Chaney et al (2009) which suggested that, in cross-country level, the discretionary accruals quality of the politically connected firms as reported by to be lower than the non-connected firms.

However, the question whether or not the political connection has an influence on the discretionary accruals could not yet be answered by this table alone. This question will be answered in the next table, **Table 5**, in which presented the regressions results between the

political connection variables, discretionary accruals along with other firm specific control variables.

Table 5 presents the results from the OLS regressions of which the dependent variable is the standard deviation of the REDCA computed in equation (1) over 5 years period (2004-2008) and 9 years (2000-2008). The principal independent variable is the proxy for political connections (SH, BM and SHBM). The control variables are ownership variables, and other firm specific control variables as suggested by previous literatures to have influence on discretionary accruals. We ran the regression twice for each period of study with SH and BM as political measure variables for our first regression and SHBM for our second regression. This is because SHBM group is the integrated data of SH and BM.

We look at the panel (1) and (3) of Table 5 to answer our first hypothesis whether political connection causes the quality of information to be lower. We find that the politically connected firms, represented by SHBM, have negative and significant relationship with the REDCA, which is the discrepancy between the expected and the actual discretionary accruals. This is true in both of our period of study, which is 5 years (coefficient = -4.915, t-stat = -4.917) and 9 years (coefficient = -2.759, t-stat = -3.63). This could infer that political connection leads to lower REDCA and, hence, higher quality of earnings information. We then reject the first hypothesis. In addition, the decrease in the coefficient of SHBM could be inferred that political connection is in the long run have less negative relation with REDCA and consequently less in causing better quality of earnings information. The quality of earnings of the connected firms is still better than non-connected firms. This perhaps could be explained that connection may need long period to result in the quality of earnings.

In order to answer the second hypothesis, we ran another set of regression to observe the different effect connecting through shareholding (SH) and boards of management (BM) have on the quality of earnings. The panel (2) of Table 5 depicts the result for the 5-year period of study and we find that the connections by shareholding and board of management are negatively related to lower REDCA. (Coefficient SH = -1.021 and BM = -4.914) The lower REDCA indicates lower discrepancy between the expected and actual, which results in better quality of earnings information. Therefore, political connection leads to better quality of earnings information. However, since the t-stat for SH equals -0.783 only t-stat for BM equals -

4.236, we could infer that only BM have significant relation towards the quality of earnings information.

For the longer period of study we will look at panel (4) which reports the coefficient for SH to be 1.799 and -4.512 for BM and t-stats of SH to be 1.112 and BM to be -6.2678. This means SH is positive but insignificantly related to REDCA and BM is negative and significantly related to REDCA. That is BM causes the REDCA to be lower and poorer REDCA leads to better quality of accounting information. With this conclusion, we reject the first part of the hypothesis that political connection leads to lower quality of earnings information. However, the two different means of connection affect the quality of accounting information differently. Only BM has a positive relationship toward the quality of earnings information.

Despite rejecting both hypotheses, political connection is considered to be benefits for connected firms because better earnings information would lead to cheaper cost of capital, better treatment by authority and investors and other benefits. It is also not come as a surprise that the connected by board of management yields higher influence than connecting through shareholding since board of director has direct power over the firms' decision and manages the firm.

Table 4 Quality of Accounting information and Political Connections

Standard deviation of REDCA of the connected and non-connected firms from 2000 to 2004 (5 years) and 2000-2008 (9 years) are displayed as followed. The REDCA or the performance adjusted current accruals estimated using the equations in section 3, is the difference between the total and expected discretionary accruals and is a measurement of accounting information quality. The two REDCA are divided into six groups by their connection characters; the connected groups are dummy variable set equal to 1 if connecting through shareholding then the group is defined SH, connecting through board and management, BM and connecting either of the two, SHBM. The non-connected firms are set equal to 0.

		REDCA_5yrs x 100		REDCA_9yrs x100	
		Observations	Mean	Observations	Mean
SH	Connected=1	49	7.620	79.	10.201
NON-SH	Connected=0	1645	11.413	2591	12.180
	Difference(t-stat)		(2.315)		(0.549)
BM	Connected=1	91	6.156	178	7.665
NON-BM	Connected=0	1583	11.624	2457	12.420
	Difference(t-stat)		(4.656)		(6.556)
SHBM	Connected=1	111	6.746	213	8.689
NON-SHBM	Connected=0	1583	11.624	2457	12.420
	Difference(t-stat)		(4.414)		(3.814)

Table 5 The Quality of earnings and Political Connection: OLS regressions

The dependent variable (REDCA_5yrs) is defined as the standard deviation over 2004-2008 of the listed firms' discretionary accruals estimated from equation 3 x100 while REDCA_9yrs represent the period over 2000-2008. SH, BM and SHBM are dummy variables for politically connected firms set equal to 1 if the company is considered connected to a politician and 0 otherwise. A company is considered connected with a politician in term of shareholding (SH) if one of the company's or holding companies major shareholders (1) have similar family name with the politician. (Member of representative or member of cabinet defined as Prime Minister, minister or deputy minister, (2) have any one of connection relationship as defined in number I-IV in the methodology section, (3) have 10% or more shareholding of the firm. Similarly a company is considered connected through board and management (BM) if at least two board and management member of the listed firm is closely related (have any one of I-IV connection condition) or have the same family name as a politician defined as representative or member of cabinet. SHBM is a group for firms that fall into SH or BM. Control is the voting stake held by the largest ultimate shareholder. Family is a dummy variable set equal to 1 if the largest shareholder is a family or individual who controls 20 percent or more of the firm's shareholding and 0 if otherwise. Operating Cycle is calculated as log of the sum of days in receivable and days in inventory while Size equals the natural log of market capitalization of the firms. The operating volatility measures are SD (CFO/TA) x100, SD (sales/TA) x100, SD (sales growth) x 100 and sales growth x100 where Market-to-book is the ratio of market capitalization over to book value of equity and Leverage is the percentage of total debt over total assets at the end of 2004.

	(1)		(2)		(3)		(4)	
	REDCA_5yrs x 100		REDCA_5yrs x 100		REDCA_9yrs x100		REDCA_9yrs x100	
	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat	Coefficient	t-stat
Intercept	3.325	0.830	3.233	0.808	4.728	1.414	5.022	1.494
SH			(1.021)	(0.729)			1.799	1.608
BM			(4.914)	(4.236)			(4.512)	(6.268)
SHBM	(4.915)	(4.917)			(2.758)	(3.633)		
Control	(0.084)	(2.215)	(0.083)	(2.200)	(0.024)	(1.009)	(0.023)	(0.961)
Family	3.073	1.603	3.038	1.582	(1.290)	(1.006)	(1.404)	(1.096)
Operating Cycle	5.966	1.745	5.971	3.424	6.323	6.669	6.255	6.583
Size	(0.404)	0.151	(0.403)	(2.656)	0.779	2.607	0.786	2.624
SD(CFO/TA)x100	0.020	4.123	0.020	4.132	0.008	2.455	0.008	2.482
SD(Sales/TA)x100	(0.009)	(0.897)	(0.009)	(0.925)	(0.003)	(0.399)	(0.004)	(0.539)
SD(Sales Growth)x100	(0.004)	(0.694)	(0.004)	(0.664)	(0.001)	(0.489)	(0.001)	(0.488)
Sales Growth x100	0.006	0.726	0.006	0.736	(0.010)	(3.308)	(0.011)	(3.338)
Market-to-book	2.451	0.780	2.459	3.143	(0.396)	(2.181)	(0.404)	(2.217)
Leverage	(3.482)	1.967	(3.299)	(1.659)	(0.950)	(1.458)	(0.869)	(1.330)
Number of observations		2254		2254		4049		4049
Adjusted R-square		6.94%		6.87%		4.78%		4.99%

4.3 The Cost of Debt

As we could observe from univariate results reported in **Table 6**, the univariate tests report that the average cost of debt of the non-connected firms is statistically higher than the connected firms in all three cases (SH, BM and SHBM) in the 9-year period of study. The maximum number of the average cost of debt in the 9-year case is 42.08 percent while the minimum number equals 0.06 percent. The difference of the average cost of debt between the connected and non-connected firms are compared by looking at the t-stat of the difference in mean and all of the cases report that differences are statistically significant or have t-stat exceeds 1.96. This result applies for both the groups with high and low quality of earnings as separated by their quality of earnings information determined by REDCA. If the firms have REDCA exceeds or equals to the sample median REDCA, they are considered to have lower quality of earnings information. Consequently, firms in the group with REDCA lower than the sample median REDCA are considered to have higher quality of earnings as compared to the former group.

For example, the firms connected through shareholding, SH group, with lower quality of earnings (have REDCA that is higher or equals to the sample median REDCA) have average cost of debt at 6.597 percent while the firms in NON-SH group with lower quality of earnings have 7.428 percent. The results for the 5-year period are reported to be quite similar to the 9-year period study with exception of two cases out of six that connected firms have higher average cost of debt than the non-connected firms and two out of six cases appear to not have statistical difference.

However, in order to determine whether the cost of debt is affected by political connection, we have to proceed to the regression analysis. We then run a regression with the cost of debt as dependent variables and controlled for other determinants of the cost of borrowing in order to validate if these results would continue to hold.

The dependent variable is the cost of debt and the political connection variables are the political connection variables. The factors known to have influence on interest rates in the regression analysis are size, leverage, the standard deviation of sales growth, the rate of growth sales, market to book, and interest coverage ratio. These factors are controlled in the OLS regression and the results are reported here. **Table 7** represents two regressions as reported in the first and second column: one for five-year period of study of the cost of debt and the other is for the nine-year period.

In order to answer the third hypothesis, we look at panel (1) that reports that connection presented as SHBM has positive but insignificant relation to the cost of debt in the short run. (Coefficient = -0.545, t-stat = -1.137) However, the results from panel (3), which shows that the connections have strong negative and significant relation towards the cost of debt in the 9-year study period. (Coefficient = -0.688, t-stat = -2.819) The explanation for this result could be explained by the fact that long period is needed to translate the signal caused by connection and affects the cost of debt. In conclusion, we accept our hypothesis in the long run.

As for the rest of the control variables, most of them except for *Size* appear to have significant relevance to the cost of debt. According to Table 7, the cost of debt is surprisingly negatively related to leverage. However, Cheney et al. (2009) and Francis et al. (2005) also reported negative relation between leverage and the cost of debt and suggested an explanation that this may have been companies who chose not to borrow because they were facing high cost of debt.

To answer hypothesis 4, we look into the reports of panel (2) and (4) of table 7. We find similar result as was reported for hypothesis 3. For the 5-year period of study, the coefficient of SH equals 0.371 while BM's coefficient equals -1.024 with the t-stat of SH equals 0.425 and BM's stat equals -2.351. These numbers indicate that both SH and BM have positive but insignificant relation towards the cost of debt. Thus, in the short-run, politically connections through shareholding (SH) and through board of management (BM) both do not cause firms to have lower cost of debt.

However, the statistic for the 9-year study, reports the coefficient of SH equals -0.414 while BM's coefficient equals -0.611 with the t-stat of SH equals -0.984 and BM's stat equals -2.246. This suggests that SH and BM have strong negative and significant relation towards the cost of debt. We then conclude that only connection which is connected through the board of management will have effect on the cost of debt of the firms.

Table 6 Discretionary accruals and the Cost of debt.

This table reports the average cost of debt for companies falling into different groups which Cost of Debt is the dependent variable and derived by calculating the firm's annual interest expense in year t over the average interest bearing obligations outstanding between the fourth quarter of t-1 and the fourth quarter of year t (x100). The average interest bearing obligations outstanding are compute using interim data when available. SH, BM and SHBM are dummy variables set equal to 1 if the firm is politically connected to a politician through shareholding, board of management and shareholding or board of management and 0 otherwise. A company is considered connected with a politician in term of shareholding (SH) if one of the company's or holding company's major shareholders (1) have similar family name with the politician as defined as member of representative or member of cabinet, prime Minister, minister or deputy minister, (2) have any one of connection relationship as defined in number I-IV in the methodology section, (3) have 10% or more shareholding of the firm. Similarly a company is considered connected through board and management (BM) if at least two board and management member of the listed firm is closely related that is have any one of I-IV connection condition or have the same family name as a politician as defined as representative or member of cabinet. SHBM is a group for firms that fall into SH or BM. REDCA_5yrs is defined as the standard deviation over 2004-2008 of the firm's discretionary accruals as estimated in equation 3 x 100 while REDCA_9yrs is defined as the standard deviation over 2000-2008 of the firm's discretionary accruals as estimated in equation 3 x 100.

		Mean of average of Cost of Debt_5yrs (%)						Total Sample
		SH	Non-SH	BM	Non-BM	SHBM	Non-SHBM	
REDCA_5yrs	≥Sample Median	5.930	6.707	4.695	6.808	7.527	6.785	
	Number of observations	39	820	30	845	42	845	
REDCA_5yrs	<Sample Median	14.106	6.272	5.331	6.200	5.106	6.138	
	Number of observations	10	825	61	788	69	738	
Difference		(0.777)	7.834	(2.113)	(0.869)	0.7423	(1.032)	
T-stat for difference in mean		(0.280)	26.168	(1.969)	(3.406)	0.5630	(4.039)	
Total observations		49	1645	91	1633	111	1583	1694
Maximum percentage of average COD		38.71	42.08	37.88	42.08	38.71	42.08	42.08
Minimum percentage of average COD		1.25	0.06	1.25	0.06	1.25	0.06	0.06
		Mean of average of Cost of Debt_9yrs (%)						Total Sample
		SH	Non-SH	BM	Non-BM	SHBM	Non-SHBM	
REDCA_9yrs	≥Sample Median	6.597	7.428	6.855	7.439	6.626	7.458	
	Number of observations	27	1312	55	1282	69	1268	
REDCA_9yrs	<Sample Median	3.910	8.886	5.720	6.629	5.749	6.621	
	Number of observations	52	1279	123	1210	144	1189	
Difference		4.98	0.83	1.135	0.810	0.877	0.837	
T-stat for difference in mean		9.510	4.521	2.495	4.262	2.034	4.400	
Total observations		79	2591	178	2492	213	2457	3753
Maximum percentage of average COD		20.52	41.67	13.90	41.67	20.52	41.67	41.67
Minimum percentage of average COD		1.14	0.37	1.14	0.37	1.14	0.37	0.37

Table 7 The Average cost of debt: OLS regressions.

Cost of debt is the dependent variable which equals a firm's interest expense at year t over the interest bearing obligation outstanding between the fourth quarter of year t-1 and quarter of year t (x100). The ratio is computed for each year between 2004-2008 and 2000-2008 then averaged over this period for each firm. REDCA_5yrs and REDCA_9yrs are the standard deviation of the firms' discretionary accruals as estimated from equation 3 x 100 over 2004 to 2008 and 2000 to 2008. SH, BM and SHBM define if the firm is political connected through shareholding, board of management and either one of the two. Interest coverage ratio is the ratio of operating income to interest expense in year 2004 where Size is measured as the ln of the firm's market capitalization as the end of year 2004. There are three operating volatility measures used as control variables here; first is the volatility of cash flow over total assets during 2004-2008, standard deviations of (CFO/TA) x 100 where CFO is income before extra item minus TCA (computed in equation 2) plus Depreciation, depletion and amortization and TA is total assets. Second is volatility of sales over total assets, which are standard deviation of (Sales/TA) x 100. The last is the annual growth of sales which are the SD (Sales Growth) x 100 and Sales Growth x 100. Leverage is the percentage of total debt over total assets at the end of 2004 whereas Market-to-book is defined as market cap over book value of equity.

	(1)		(2)		(3)		(4)	
	COD_5yrs x 100		COD_5yrs x 100		COD_9yrs x 100		COD_9yrs x 100	
	Coefficient	t-stats	Coefficient	t-stats	Coefficient	t-stats	Coefficient	t-stats
Intercept	7.476	13.317	7.475	13.320	8.634	15.128	8.625	15.114
REDCA_5yrs x 100	0.010	2.446	0.010	2.425				
REDCA_9yrs x 100					0.005	1.332	0.004	1.310
SH			0.371	0.425			(0.414)	(0.984)
BM			(1.024)	(2.351)			(0.611)	(2.246)
SHBM	(0.545)	(1.371)			(0.688)	(2.819)		
Interest coverage ratio	(0.000)	(3.422)	(0.000)	(3.304)	0.000	1.371	0.000	1.364
Size	(0.033)	(0.524)	(0.028)	(0.442)	(0.121)	(3.504)	(0.121)	(3.496)
SD(CFO/TA) x 100	0.002	2.242	0.002	2.235	0.005	7.678	0.005	7.691
SD(Sales/TA) x 100	0.011	3.117	0.011	3.110	(0.002)	(1.597)	(0.002)	(1.607)
SD(Sales Growth) x 100	0.000	0.288	0.000	0.284	0.005	6.409	0.005	6.444
Sales Growth x 100	0.004	4.827	0.004	4.796	(0.001)	(1.257)	(0.001)	(1.256)
Market-to-book	(0.127)	(3.196)	(0.128)	(3.199)	(0.033)	(0.587)	(0.031)	(0.553)
Leverage	(1.245)	(1.782)	(1.162)	(1.656)	(1.686)	(3.919)	(1.677)	(3.910)
Number of observations		2254		2254		4049		4049
Adjusted R-square		4.12%		4.21%		3.75%		3.71%

4.4 Market Reaction towards Earnings Announcement

The results for the market reactions towards earnings announcement are presented here in 6 cases in order to compare the effect political connection in terms of market reaction towards earnings announcement. Each figure represents the event study test of annual earnings announcement of the firms listed in the SET during 2000-2008, which have an event study window of 80 days, a timeline of daily returns 60 days prior to the announcement date and 20 day after the announcement date. We analyze these figures in order to answer the fifth hypothesis.

The political connected groups in this study are divided into 3 similar groups as the study in other section which is connecting through shareholding group (SH), connecting through board and management(BM) and connecting through shareholding or board and management group (SHBM). Before we could compare among each group which have non-connected group of their own (NON-SH, NON-BM, NON-SHBM), we had to deduct the effect of positive and negative earnings by comparing the connected and non-connected group in the case of positive change in net income and negative change in net income or the good and bad news. We try to look into the pattern of market reaction to determine the volatility of the stock price and found that only in the case of connection caused by the board of management (BM) has lower volatility of stock prices as observed by the cumulative abnormal returns around the earnings announcement. The results could be observed in the following figures.

Figure 1: Market reaction towards positive change in annual earnings report during 2000-2008 between the politically connected firms through shareholding group.

This figure shows abnormal volumes around positive annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through shareholding. The period of this event study is 59 days before the announcement and 19 days after the announcement.

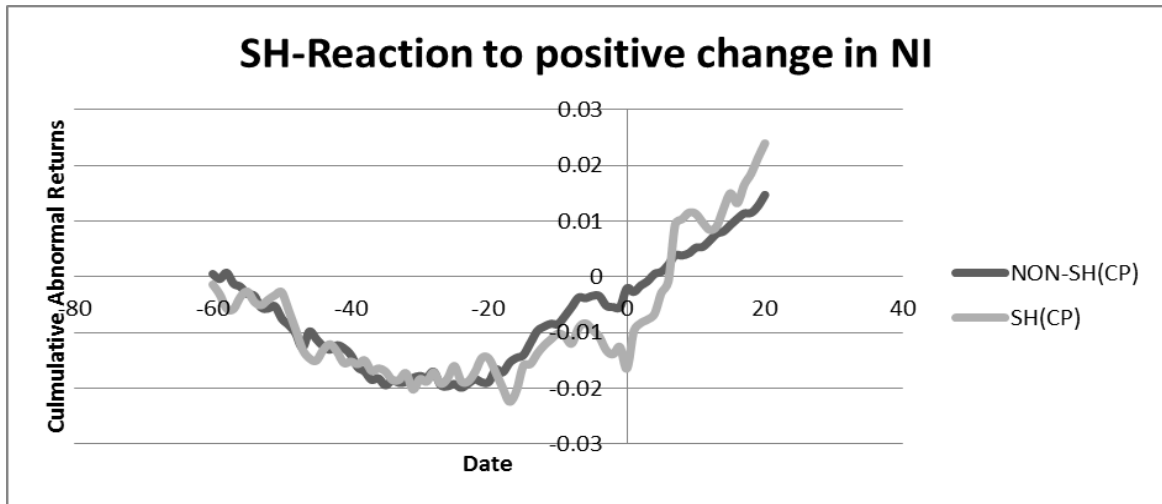
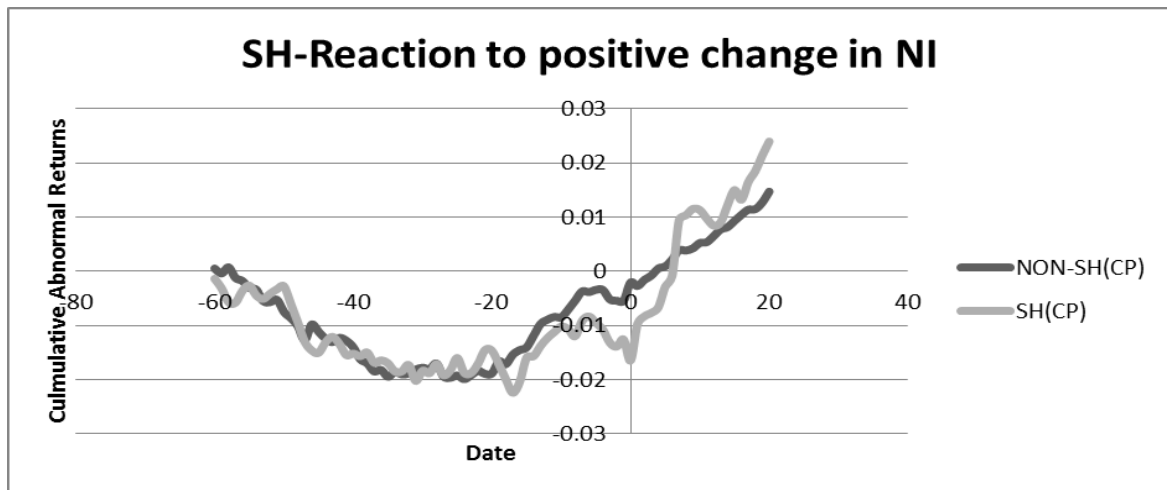


Figure 2: Market reaction towards negative change in annual earnings report during 2000-2008 between the politically connected firms through shareholding group.

This figure shows abnormal volumes around negative annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through shareholding. The period of this event study is 59 days before the announcement and 19 days after the announcement.



From figure 1, we find that the market reaction of the connected group (SH) appears to have lower magnitude of the stock price in comparison to non-connected group (NON-SH). However, we could see that SH have frequent shocks towards the positive change than NON-SH. In figure 2, both the non-connected and connected firms appear to have a similar pattern in

their market reaction but SH also have frequent and drastic shocks. Therefore, we could infer that SH have higher volatility than the non-connected firm or NON-SH.

Figure 3: Market reaction towards positive change in annual earnings report during 2000-2008 between the politically connected firms through board and management group.

This figure shows abnormal volumes around positive annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through board of management. The period of this event study is 59 days before the announcement and 19 days after the announcement.

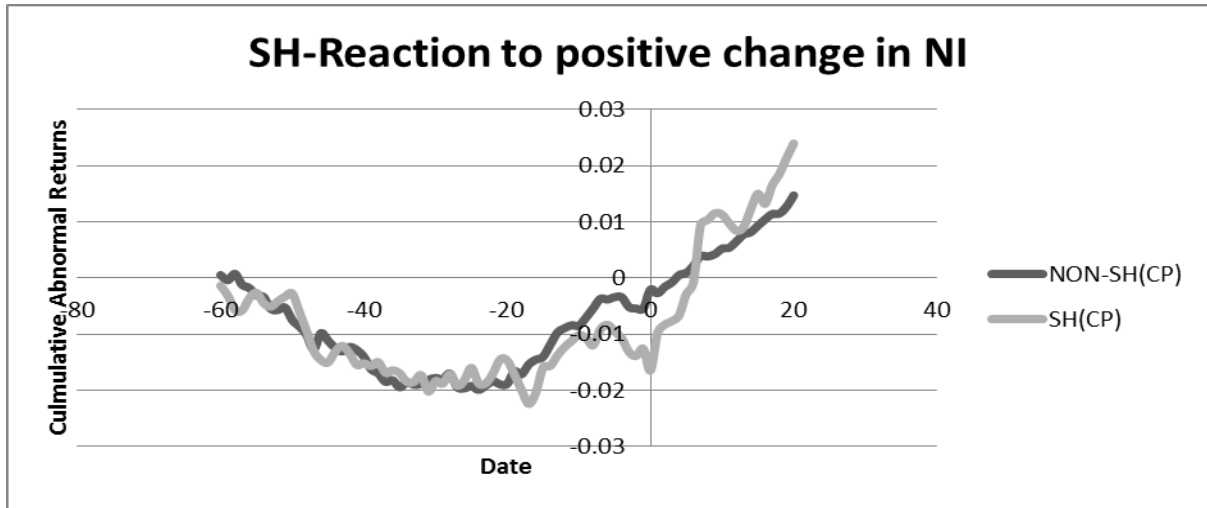
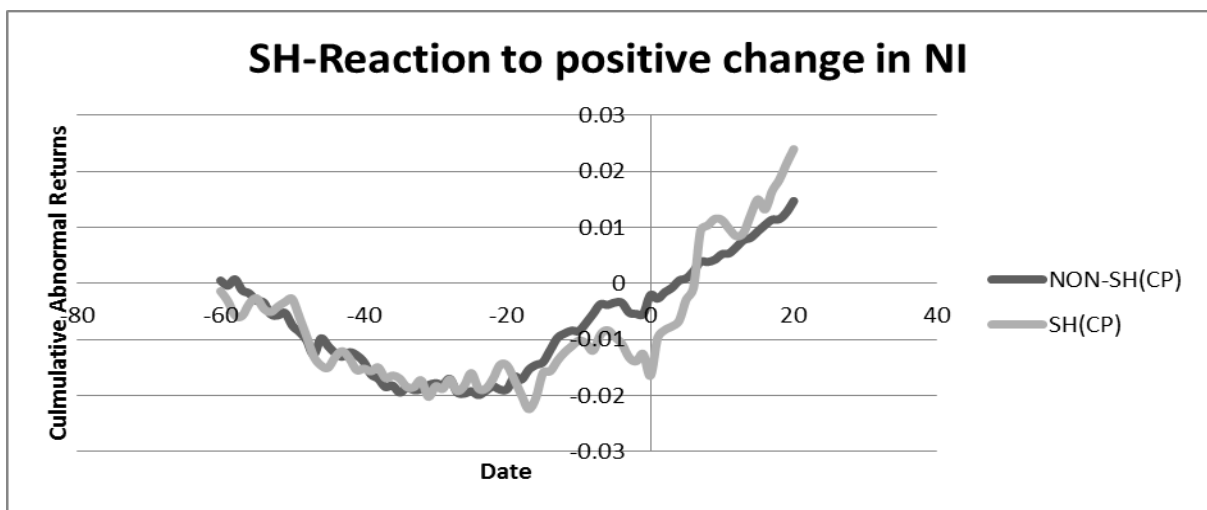


Figure 4: Market reaction towards negative change in annual earnings report during 2000-2008 between the politically connected firms through board and management group.

This figure shows abnormal volumes around negative annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through shareholding. The period of this event study is 59 days before the announcement and 19 days after the announcement.



From figure 3, we find that the market reaction of the connected group (BM) appears to have lower magnitude of the stock price in comparison to non-connected group (NON-BM) when there is positive change in income. We could observe that BM has less frequent shocks towards the positive change than NON-BM. In figure 4, the non-connected firms appear to have frequent and drastic shocks while the pattern of returns of the connected firm looks smoother. Therefore, we could infer that BM has lower volatility than the non-connected firm or NON-BM.

Figure 5: Market reaction towards positive change in annual earnings report during 2000-2008 between the politically connected through shareholding or board and management group.

This figure shows abnormal volumes around positive annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through shareholding or board of management. The period of this event study is 59 days before the announcement and 19 days after the announcement.

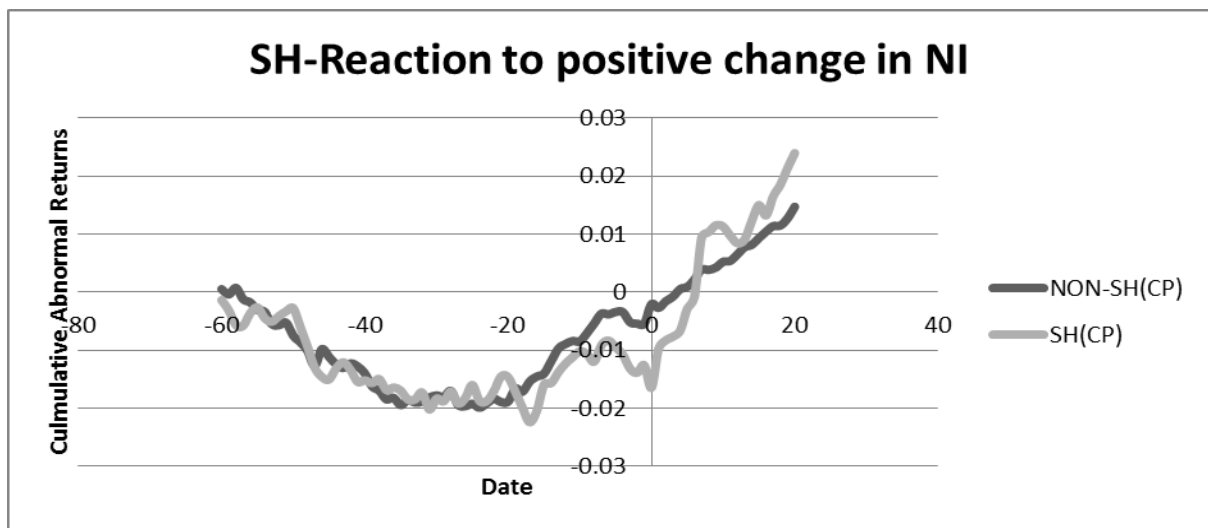
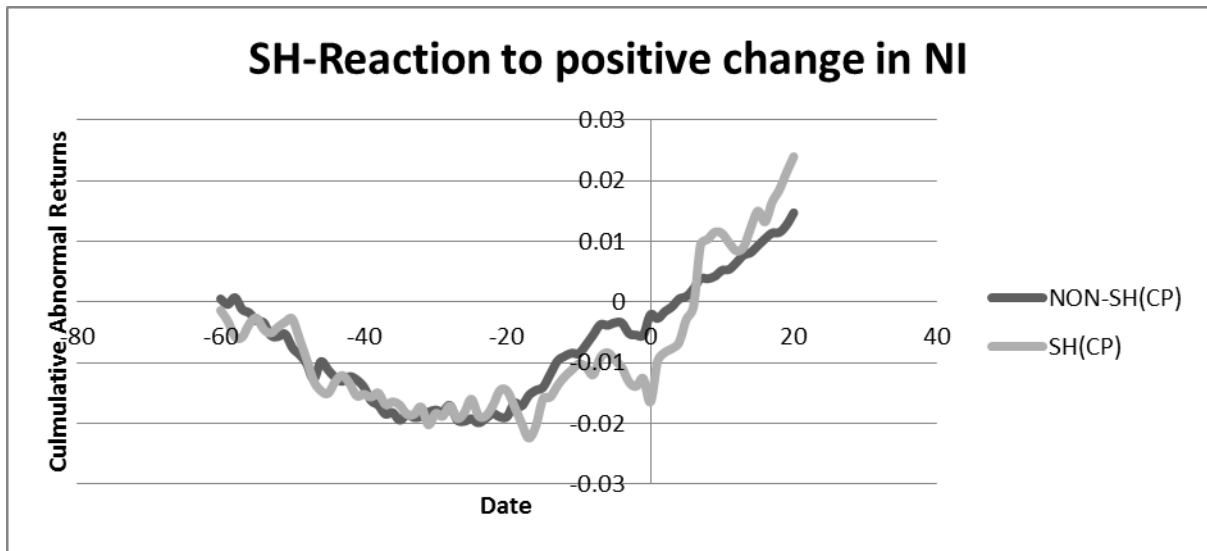


Figure 6: Market reaction towards negative change in annual earnings report during 2000-2008 between the politically connected through shareholding or board and management group.

This figure shows abnormal volumes around negative annual earnings announcement through 2000 to 2008. The sample is divided into two groups of connected and non-connected firms through shareholding or board of management. The period of this event study is 59 days before the announcement and 19 days after the announcement.



The last two figures, figure 5 and 6, show the reaction of the market toward the earnings announcement between the connected groups through shareholding or through board of management. The connected group (SHBM) appears to have higher magnitude in the case of positive net income and but lower in the case of negative net income. However, the NON-SHBM or the non-connected firms have frequent and more drastic stock price jumps in comparison to SHBM. Therefore, SHBM or the politically connected firms has higher volatility than the non-connected firm or NON-BM.

In conclusion, it could be inferred that the connection through board of management may results in some kind of benefits in terms of lower volatility of stock price towards earnings announcement if we assume that investors have the knowledge of some firms being politically connected. However, if we focus on the market reaction in terms of the patterns of the stock price, the connected and non-connected firms appear to be similar.

CHAPTER V: CONCLUSION

This chapter represents the conclusion to the findings of this thesis as well as its limitation and the author's recommendation for future improvement of the study in the area of politically connected firms and the quality of earnings information.

5.1 Conclusion

This thesis investigates the issue of political connection and finance by looking into a sample of 2689 firms listed on the Stock Exchange of Thailand during 2000-2008. Firstly, it adopts the concept of connection, and respectively allocates connected firms into three groups with regard to the nature of their political connection. The first group consists of firms that have related persons to politicians – those sharing the same surnames of politicians – as shareholders, holding at least 10 percent of shares in the firm (SH). The second group consists of firms having at least 2 board of directors connected with a politician (BM). The third group consists of firms having connections both through their shareholders and the board of directors (SHBM).

Secondly, this paper compares the characteristics of the connected and non-connected firms. Such characteristics include the industry within which the firm operates, its size, leverage, debt to equity ratio, total assets, total debt, market capitalization, and ownership concentration. The paper also examines the concentration of connected firms and its fluctuation year-to-year. The main finding in this section suggests the connected firms have higher leverage and ownership concentration than non-connected firms.

Thirdly, this paper looks into its main issue that political connection can result in lower quality of earnings information and employs the performance-adjusted current accruals measure of the discretionary accruals to investigate this issue. Prior researches on politically connected firms in Thailand have focused mostly on accounting and market performance indicator, such as ROA and stock returns, and showed mixed results on whether political connections have a positive effect on Thai firms. It is thus the quality of earnings is considered another important and interesting factor to investigate with regard to politically connected firms. The results of this section, however, do not concur with the hypothesis of this thesis. In conjunction with Chaney et al (2009) we expected connected firms to have higher standard deviation of REDCA, which signifies lower quality of earnings information. In contrary to Chaney et al,

however, the connected firms in most of the cases in our research appear to have higher quality of earnings for both periods of our study – 5 years period and 9 years period –in the univariate report. More importantly, our regression analysis suggest that political connection leads to lower REDCA and, hence, higher quality of earnings information. We could infer from this conclusion that politically connected firms have better quality of earnings in the case of the listed firms in Thailand during 2000-2008.

This could be explained by the highly concentrated ownership structure dominant in Thailand. According to previous researches, low quality of earnings suggests high probability for earning management, and that connected firms will suffer more from the agency cost problem. In Thailand firms tend to have high level of ownership concentration and sometimes coupled with little separation of ownership and control, where many major shareholders of a firm are also involved in its management. This alignment of owner and management interests can lessen agency problems in a firm, and may be reflected in the lower problems found in earning management issues and quality of accounting information issues.

Fourthly, the paper also proposed politically connection causes the cost of debt to be lower for the connected firms. Our univariate results for the cost of debt report that in most cases the connected firms have lower cost of debt. Our regression analysis suggests that this is caused by political connection in the specific case that the connection is connected through the board of management. Finally, the final finding from the event test of market reaction reports that connected and non-connected firms have similar patterns of market reaction towards earnings announcement as observe by the abnormal returns of the stock prices. In addition, if we look at roughly in terms of the volatility of the stock price, the political connection by board of management somewhat has positive effect on connected firms' share prices stability as observed from investor's reaction on firms' earnings announcements.

The study of political connection is difficult not only because the information on the political connectedness is hard to acquire but also the fact that the benefits of political connection might come not separately. In other word, there is a bundle of the benefits political connection, which may be different in shape and form amongst firms and countries. By singling out specific benefit from political connection in terms of quality of accounting earnings and getting insignificant results may suggest that this issue is tedious. However, the academic world still keeps on reproducing the study on politically connected firms and trying to document what that are known for practitioners into evidence. I hope that the finding in this paper will lead to a

better understanding in the aspect of the debt and equity benefits firms get from political connection in which this paper has made would provide a better approach in this issue. I will suggest the area which improvement could be made in the following section.

5.2 Limitations

The first limitation of this study is the incomplete accounting and qualitative data. Some data were missing from the database used, thus, some firms are excluded from the study from this reason. In addition, the data on political connection and ownership concentration are also difficult to acquire especially in the study of which the period of study is quite long (9 years).

Secondly, this study used only one method in the finding of the cost of debt, which is finding the average cost of debt using quarterly interest rates. However, the cost of debt could also be found using the bond issuance approach, which may give a better approximation of the cost of debt according to Chaney et al (2009). This method was omitted in this study due to the unavailability of the data. Finding the cost of debt using this method would surely help confirming the results of the paper on the cost of debt. Also, finding the cost of debt might be complementary to this study if the political connections provide benefits for firms in terms of quality of accounting information. If that was not the case, then the cost of debt may complicate the finding. The extra finding of the market reaction of the connected and non-connected firms is not very helpful in concluding the main investigation because this paper was only able to investigate the reaction in terms of stock price but not trading volume. The other prospects that should be more than earnings include market reaction towards IPO, merging and acquisition or even political events such as important political events and elections.

5.3 Recommendation

There are several limitations to this study that may translate into the finding as discussed above. Room for improvements is required because political connection is still an important issue as well as the market information.

First of all the data on political connection could be improved further researches, connected firms could be allocated into groups using additional criteria to those employed in this paper. Firms could be divided into groups according to the type of politicians they are connected to, for instance, connecting through cabinet members or representatives. Stretching the source of

connection into holding companies and adding more indirect connection could also help improving the political connection database.

Moreover, this thesis replicates the method used in measuring the quality of accounting information from Chaney et al. (2009), which published the comparative study of the connected firms in terms of quality of accounting information among countries. There are other methods that could be used in measuring the difference between actual and expected accruals that could be used instead of the method used in this paper. This also applies as the measuring of the cost of debt with could be found. In addition, the ownership concentration could also get more attention in this study.

In the section of the event study of the earnings announcement, this paper only focused on cumulative abnormal returns so incorporating the study of stock variance trading volume would help fulfill the investigation in this part.

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