AGENCY COST REVISITED: THE CASE OF THOMAS COOK

Anna Constantatos
Assistant Professor, Department of Accounting, Economics and Finance
School of Business and Economics
The American College of Greece
6 Gravias Street GR-153 42
Aghia Paraskevi, Greece
Tel: +30 210 600 9800 ext 1330
Fax: +30 210 600 9811
aconstantatos@acg.edu

Anna Merika
Professor, Department of Accounting, Economics and Finance
School of Business and Economics
The American College of Greece
6 Gravias Street GR-153 42
Aghia Paraskevi, Greece
Tel: +30 210 600 9800 ext 1392
Fax: +30 210 600 9811
merikas@acg.edu

Anna Triantafyllou
Professor, Department of Accounting, Economics and Finance
Dean, School of Business and Economics
The American College of Greece
6 Gravias Street GR-153 42
Aghia Paraskevi, Greece
Tel: +30 210 600 9800 ext 1364
Fax: +30 210 600 9811
atriant@acg.edu

Abstract
This paper investigates the extent to which the collapse of Thomas Cook in September 2019 is attributable to agency issues. Extracting data from company reports and Bloomberg for the period 2008 to 2018, we compare evidence for Thomas Cook against a control group comprising 67 firms in the industry. We substantiate three sets of agency causes for the collapse of Thomas Cook. First, we document that after 2014 CEO compensation at Thomas Cook was significantly above the control group average. Second, we discover a positive relationship between probability of survival and CEO compensation for the control group, but a negative, highly significant association of the probability of survival and CEO compensation in the case of Thomas Cook. Third, we ascertain a positive relationship between CEO compensation and earnings management practices with Thomas Cook earnings management being consistently higher than the control group since 2012, after recovery from its 2011 default.

Keywords: *agency theory, management compensation, earnings management, corporate governance structure*

EFM codes: 110, 190, 150, 180

1. Introduction

The history of the UK landmark travel agent Thomas Cook is no ordinary "rise and fall" story of the kind that is common in the recent history of finance. Thomas Cook is not a high-tech company of the young, dotcom-type that went bust in 2000 nor is it a telecom growth company of the Canadian Nortel type that sank in 2002. With a life span spreading over three centuries, Thomas Cook has been a key player in the highly competitive international travel and leisure industry since the 1980s. Following its collapse and while its customers were still stranded in airports all over the world, a plethora of press reports pinpointed fat compensation packages of recent CEOs of the company as being critical for its downfall. Manny Fontenla- Novoa, who had led the series of acquisitions that ended up burdening Thomas Cook Group with over £1bn of debt, received more than £17m plus bonuses in about four years, before he resigned when the tour operator almost crashed in 2011. He was succeeded by Harriet Green who received £4.7m for about three years plus a bonus in company stocks worth a further £5.6m. Peter Fankhauser, who was in charge when the company collapsed, received £8.3m, including £4.3m in bonuses (*The Guardian*, September 23, 2019).

This paper argues that the travel firm's irreversible troubles are primarily attributable to agency issues. Following Fogarty et al. (2009), we concentrate on the investigation of sources of agency conflict, such as management compensation, earnings management practices, and corporate governance variables. We hypothesize that challenges associated with these areas are key in the collapse of the world's oldest travel business. Since the seminal work of Jensen (1986), there is abundance of studies documenting the relationship between different dimensions of agency conflict and

corporate performance drawing evidence from large samples of companies usually belonging to the same industry and deploying statistical analysis to generalize and derive policy conclusions. While earlier studies delve into corporate governance mechanisms scrutinizing their impact on corporate performance at the industry level, less light has been shed so far on quantifying the company-specific context to depict its role in shaping agency conflicts. Furthermore, agency theory has not been widely used in analyzing the behavior of tourism firms (Song et al., 2012). Additionally, Song et al. (2013), clearly state that the tourism industry exhibits unique governance characteristics and highlight the need for research in this industry. To fill these gaps in the literature, we adopt a clinical approach, conducting an empirical analysis to reveal the degree to which the fall of the renowned travel agent is attributable to principal-agent conflict manifestations.

Overall, the results obtained for the case of Thomas Cook are consistent with those found for its peers. This is true for the positive and significant association found between earnings management and CEO compensation, as well as for the negative and significant relationships depicted between the corporate governance characteristics studied (frequency of audit committee meetings, frequency of board meetings, board diversity) and CEO compensation, corroborating agency theory. The positive association found between board independence and CEO compensation in both Thomas Cook and control group analysis indicates that in the case of the tourism industry independent boards are rather ineffective in monitoring top management teams in general and their compensation in particular, which is more in line with rent extraction explanations (Chalmers et al., 2006). More importantly, the GMM methodology deployed in this study reveals a striking difference between Thomas Cook and a control group of UK listed

firms form the travel and leisure industry that we selected for the purposes of comparison. Specifically, the positive relationship between the probability of survival and CEO compensation, which is found to be significant for the control group, is not corroborated by the findings for the case of Thomas Cook: the analysis shows a highly significant, negative association of firm survival and CEO compensation, confirming our central hypothesis that the level of CEO compensation was instrumental in the failure of Thomas Cook and the crest of the agency challenges faced by the company.

The rest of the study is organized as follows. Section 2 gives a brief timeline of the company. Section 3 reviews pertinent literature. The hypotheses tested in the study are presented in Section 4. Section 5 presents a couple of stylized facts on CEO compensation and earnings management practices over the period considered. Section 6 outlines the methodology and data used and section 7 presents results and discussion. Conclusions and policy implications are offered in section 8.

2. Timeline of the rise and fall of Thomas Cook[i]

Thomas Cook was founded in the mid-nineteenth century by a cabinetmaker and former Baptist preacher, who thought of making use of the nascent railway network of Britain to get working class families out of their homes when they had a day or two off work. Thomas Cook would organize his first rail daytrip from Leicester to Loughborough for a temperance meeting against alcohol drinking in 1841. In the years to come, the founder would sense the importance of the development of railways and would augment rail travel across Britain and beyond, to the continent, as early as 1855. Ten years later, Thomas Cook & Son would pioneer organizing tours in America, Asia, Africa, and trips around the world. More innovation would follow in 1874 with the introduction of "Cook's Circular Note", the forerunner of the traveler's check, which would be launched by the company in America. Such would be its reputation that in 1896 Thomas Cook & Son would be appointed Official Passenger Agent for the first modern Olympic Games in Athens.

In the 1920's, the company ceased to be a family firm as Thomas Cook's grandsons sold it to the Compagnie Internationale des Wagons-Lits et des Grands Express Européens, owners of the Orient Express. The dawn of the 20th century was the time of air travel expansion. As with the railways in the second half of the 19th century, the company benefitted from breaking into this new market up until the Second World War when Thomas Cook became state-owned under the British Transport Holding Company. In the postwar years, the company would make a comeback as higher incomes led to robust demand for holiday travel. Eventually, Thomas Cook returned to private ownership and was run by a consortium comprising Midland Bank, Trust House Forte,

and the Automobile Association (AA) from 1972 to 1992, when it was acquired by Westdeutsche Landesbank, Germany's third largest bank, and the LTU Group, Germany's leading charter airline acquired the firm.

In recent history, 2001 marks the sale of Thomas Cook to C&N Touristic AG, one of Germany's largest travel groups, and beginning of a new era as the company starts operating an airliner. Signs of decline became visible in 2007, following the merger with MyTravel that left the company heavily in debt. Restructuring efforts in the years to come did not manage to turn the company around. Thomas Cook Group plc nearly collapsed in 2011, but was bailed out by banks. The next time it would come at the verge of collapse, in September 2019 there was to be no bail out for the Group. The banks requested £200 million immediately, leading the company to announce liquidation and, with it, the end of the Thomas Cook era. The global tour operator and airliner sank under its £1.7 billion debt on September 23 2019, stranding 150,000 holidaymakers in airports around the globe and leaving 21,000 employees without a job (Reuters, 23/09/2019). The FTSE100, that the company's share had been a part of since 2007, shed 0.26% on that day (Reuters, 23/09/2019). By contrast, the FTSE 350 travel and leisure index gained 1% reaching its highest level in almost a year, as Thomas Cook's collapse was perceived to benefit its rivals in a market thought to be quite saturated (Reuters, 23/09/2019).

3. Literature Review

Agency theory explains executive compensation by linking CEO (agent) rewards to the performance of the corporation. CEO compensation can help mitigate agency costs incurred to the corporation by agents who tend to pursue activities in their own favour and to the detriment of owners (Fama, 1980). In spite of the plethora of studies in this field, no consensus has been reached on whether executive compensation is efficient or whether it conforms to the prediction of the principal-agent theory empirically (Gupta & Bailey, 2001; Fessler, 2003; Malmendier & Tate, 2004). On the one hand, the "optimal contracting" approach supports that generous compensation schemes are designed to provide managers with efficient incentives to maximize shareholder value and mitigate agency issues (Bebchuck & Fried, 2003) by linking the agent's compensation to firm performance (Fogarty et al., 2009). On the other hand, in the "managerial power" approach, executive compensation is viewed as a potential instrument for addressing the agency problem, but also as part of the agency problem. Geiler & Renneboog (2011), for example, study the level and mix of pay, pay-for-performance sensitivity, relative performance evaluation, and severance pay and observe that although under the classical perspective executive remuneration is an efficient market-based mechanism for aligning the incentives of the agent with the interests of the principal, the view of managerial power regards remuneration both as a potential remedy for the principal-agent problem, as well as part of the problem itself (Geiler & Renneboog, 2011).

Bebchuk & Fried (2003) advocate a managerial power and rent extraction approach that elucidates aspects of compensation schemes left unexplained by optimal contacting models. They discover that the managers' influence over their own pay might

impose substantial costs on shareholders by diluting and distorting managers' incentives and, thereby, might hurt corporate performance. More recently, Gayle et al. (2018) claim that executive compensation corroborates with the principal-agent theory, albeit each variable needs to be identified, modeled and estimated bearing in mind both measurement problems and unobserved variables that may affect principal-agent forecasting.

Perhaps the question that matters more than whether company performance drives executive compensation (Core et al., 1999) is whether higher executive pay contributes to company performance improvement. On this issue, Oehmichen (2020) argues that even if large compensation is awarded to the CEO, it does not necessarily imply that company performance will improve. Furthermore, Fogarty et al. (2009) find that the compensation of the chief executive officer plays a significant role in the dysfunctionality of the board and thus adversely impacts performance of a company by negatively affecting the confidence of investors. In the same line of argument, Smirnova & Zavertiaeva (2017) and Kuo et al. (2013) show that excessive executive compensation is not linked with improvements in performance, the rationale being that the larger the amount that has to be deducted from equity earnings and distributed to the executives, the smaller the amount retained and directed to reinvestment. Garnes and Mathisen (2014) examine the mediating effect of boardroom behaviors, such as intragroup conflicts and effort norms, on the influence of directors' compensation on their organizational commitment. They find that compensation influences directors' organizational commitment in the context of boardroom behavior. Moreover, Al Najjar (2017) depicts both board characteristics, such as size, independence and meetings, as well as CEO characteristics, such as tenure and experience, to determine CEO pay in the travel and leisure industry. Al Najjar's

(2017) findings suggest that board size is negatively related to CEO pay, while board independence is positively associated to CEO pay in line with the rent extraction theory. With respect to CEO characteristics, age and tenure are found to be positively associated with CEO compensation.

As regards board structure, prior research supports that boards are conducive to agency problems when they are too friendly to managers, reducing board independence. By contrast, agency problems are thought to be mitigated through independent boards that are nominated and elected by shareholders, comprise nonexecutive directors and monitor management (Aguillera & Jackson, 2003). There are several benefits for the firm associated with a sound board structure. First, stronger board governance constrains earnings management through restructuring real business activities (Ge & Kim, 2014). Second, independent board members can articulate more objective opinions and help attain balance of power between suppliers and users of a company's resources (Uribe-Bohorquez et al., 2018). Indeed, prior research has shown that independent board members are associated with increased financial performance in tourism companies (Al-Najjar, 2014). Moreover, there is evidence that firms with a gender diverse and independent boards of directors are adopting restrained earnings management practices, especially in low debt companies (Arun et al., 2015). Other dimensions of board structure, such as size and multiple obligations of board members may also influence the incidence of agency costs (Fogarty et al., 2009).

In the same line of reasoning, Conyon and Peck (1998) advocate that management pay and firm performance are more aligned in the presence of a high proportion of outside directors, either on a main board or serving on the compensation committee, with

board independence being considered as a corporate governance device that reduces opportunistic behaviour and supervises board decisions, including CEO compensation. In contrast, Core et al. (1999) and Main et al. (1995) show that CEO compensation is positively influenced by the percentage of outside directors appointed to a board by its CEO. Their findings suggest that outside directors are ineffective in monitoring top management teams. Finkelstein and Hambrick (1996) assert that outside directors' low financial stakes and low equity holdings may reduce their board monitoring abilities. Westphal and Zajac (1995) show that powerful CEOs seek to appoint directors who will serve their own interests. Similarly, relatively recent research in specific country and industry contexts appears to suggest a positive association between board independence and CEO compensation (see, for example, Ntim et al., 2015; Ntim et al., 2017; Benkraiem et al., 2017). A few studies depict no relationship at all between the proportions of independent directors and CEO compensation. For example, Mangel and Singh (2012) find that the percentage of independent board directors does not have a significant effect on CEO compensation.

Obviously, shareholders, management, rivals and, where appropriate, regulators look forward to enhanced firm financial performance. Therefore, company announcements of financial results are important to all parties interested in firm performance. Given that the notion of trust in finance is key, what is even more important than positive financial results and/or in accordance with market expectations is the assertion that each firm announcement contains truthful and reliable financial data. Often, however, the announcement of results is taken as an opportunity to communicate to the markets a picture of the firm that is quite different from reality. For this reason and in

spite of the apparent positive relationship of earnings management with future profitability[ii], there is a deeply negative connotation associated with the concept of earnings management. Usually, earnings management is taken to imply manipulation of true financial data in order to proceed with making announcements about results that are more favorable for the firm and for the image of the manager. As put by Fogarty et al. (2009), earnings manipulation lies in the very heart of agency theory, as there would be none at all in the absence of agency, assuming that the owner is not likely to fool themselves.

Aerts et al. (2013) document the negative impact of earnings management upon firms via blurring managerial performance, accentuating information asymmetries and provoking regulatory sanctions imposed on the firm. The survey of senior managers conducted by Graham et al. (2005) stresses the concern about pressures on the part of investors when they suspect earnings management practices. Hunton et al. (2006) corroborate this concern by highlighting that detection and exposure of earnings management practices is damaging for company reporting reputation and for company valuation. Companies try to mitigate the adverse implications of earnings management expanding practices of disclosure, changing the language that the company uses when making announcements, and increasing the provision of appropriate and credible explanations for the management of earnings (Aerts et al., 2013).

Similar to having a detrimental impact on financial performance, earnings management brings default closer. Several studies substantiate the higher default risk associated with firms that engage in earnings management. Ge and Kim (2014) study the relationship between real earnings management and the cost of new bond issues in the

US, investigating three types of real earnings management, namely sales manipulation, overproduction, and abnormal reduction of discretionary expenditures. They assert that all three types of earnings management harm firms' credit rating. Higher perceived default riskiness manifests itself in higher yield spreads, as investors require high-risk premia. Thus, earnings management is taken to be a default risk-increasing factor. In the same line of argument, Lin et al. (2016) who model default prediction via earnings management indicators in the case of Chinese listed companies, find that a credit scoring model adjusted for real earnings management is consistently more accurate than the unadjusted scoring model in the case of financially non-distressed firms. More recently, Chen et al. (2019) investigate whether dividend payments that originate from unrealized or realized earnings affect the default risk in the case of Israeli firms. The authors find that firms are four times more likely to default and to require debt restructuring if they distribute dividends based on unrealized earnings, even though the market fails to reflect their increased riskiness through analogous changes in the cost of debt.

Sound corporate governance characteristics are likely to be associated with diminished earnings management as shown in a plethora of studies using data from different contexts. For example, Xie et al. (2003), who study 330 S&P listed firms, find an associative, albeit not clear as to the direction of causation, link between boards, audit committees and earnings management. The composition of the audit committee is associated with the level of earnings management, with the proportion of audit committee members with corporate or investment banking backgrounds being negatively related to the level of earnings management. Thus, the authors conclude that board and audit committee members with corporate or financial backgrounds are associated with firms

that have smaller discretionary current accruals. Similarly, Garcia-Meca and Sanchez-Ballesta (2009) find that independence of the audit committee, along with independence of the board of directors and large board size reduce the occurrence of earnings management, thereby strengthening the confidence of investors in the company.

Xie et al. (2003) also depict an association between lower levels of earnings management and the meeting frequency of boards and audit committees, stressing that board and audit committee meeting frequency mitigate the practice of discretionary current accruals and that board and audit committee activity and their members' financial sophistication are important factors in constraining the propensity of managers to engage in earnings management. In the same line of argument audit committee independence and frequency of meetings go hand-in-hand with improved performance and mitigated practices of earnings management. Lin et al. (2015) find a significant and positive association between audit committee independence and experience on the one hand and earnings management on the other. Moreover, Cenciarelli et al. (2018) report that based on their research on US firms for the period 1992–2014, firms audited by industry-expert auditors, large audit firms and long-tenured auditors appear to be less likely to default, while the inclusion of auditor attributes enhances the predictive ability of bankruptcy prediction models.

4. Hypotheses

Our overarching hypothesis is that CEO pay is key in the default of Thomas Cook, standing out as significantly and negatively affecting the probability of survival of the firm. To substantiate our argument we perform the analysis of Thomas Cook in parallel to the control group that consists of 67 travel and leisure industry firms. The composition of the control group is based on UK listed firms of the travel and leisure industry. Our control group sample includes 737 firm-year observations for 67 UK travel and leisure listed firms (unbalanced panel data) for the period 2008 to 2018. As a general rule for the sets of hypotheses tested, we expect the results obtained for Thomas Cook to be consistent with those obtained for the control group, with the probability of survival of the firm being the notable exception. The latter is expected to be negatively associated with CEO compensation. Following agency theory literature, six hypotheses sets are tested for Thomas Cook and the travel and leisure industry control group respectively.

We start by combining CEO compensation and corporate governance variables to investigate potential determinants of the probability of avoiding default, the latter defined through Altman's (1968) Z-Score. In principle, CEO compensation is a function of firm value maximization (Jensen, 2001). Recent research, however, indicates asymmetric responses of CEO pay to positive and negative shocks in firm performance, with CEOs generously compensated for good performance, but not punished for poor performance (Olaniyi, 2019). This may be crucial for the relationship between CEO compensation and firm survival, especially because there is support in the literature for disastrous effects of high CEO compensation upon firm survival (for example, Lin et al., 2013). Thus, we construct our first hypothesis set expecting CEO compensation to be positively associated

with the probability of firm survival of the firm for the control group, but negatively associated with firm survival in the case of Thomas Cook:

H1a: The probability of survival (Z-score) is negatively associated with CEO compensation in the case of Thomas Cook.

H1b: The probability of survival (Z-score) is positively associated with CEO compensation in the case of the control group.

The consensus that CEO compensation acts as an incentive to making a higher degree of earnings management more likely is justified by the findings of a plethora of studies that assert the positive relationship between CEO compensation and earnings management (see, for example, Meek et al., 2007; Harris et al., 2019). Based on prior research, therefore, we formulate our second hypothesis set as follows:

H2a: Earnings management practices are positively associated with CEO compensation in the case of Thomas Cook.

H2b: Earnings management practices are positively associated with CEO compensation in the case of the control group.

Corporate governance characteristics, such as board diversity, frequency of board meetings, frequency of audit committee meetings, and board independence are related to firm performance (Jensen, 1993; Yermack, 1996; Larcker et al., 2005). Such characteristics reflect transparency and internal control mechanisms in place that may well play a role in the level of CEO compensation. In the case of board diversity, Bugeja et al. (2015) show that excess CEO compensation falls with enhanced board diversity. Gender diversity contributes to adequate corporate leadership, thus helping mitigate

agency conflicts. Prior research has shown that the participation of women in the board of directors is associated with increased corporate performance in tourism companies (Yeh and Trejos, 2015). In this context, we expect that:

H3a: There is a negative relationship between board diversity and CEO compensation in the case of Thomas Cook.

H3b: There is negative relationship between board diversity and CEO compensation in the case of the control group.

As formal processes of monitoring and control, both board and audit committee meetings are important for sound corporate governance. Specifically, the frequency of board and audit committee meetings is an indicator of the extent of control upon the firm, which is key for its financial performance in general and CEO compensation, in particular (Ntim and Kofi, 2011). Thus, we investigate the following additional sets of hypotheses:

H4a: There is a negative relationship between frequency of board meetings and CEO compensation in the case of Thomas Cook.

H4b: There is negative relationship between frequency of board meetings and CEO compensation in the case of the control group.

H5a: There is a negative relationship between the number of audit committee meetings and CEO compensation in the case of Thomas Cook.

H5b: There is negative relationship between the number of audit committee meetings and CEO compensation in the case of the control group.

Prior research on board independence is inconclusive. One strand of the literature provides evidence supporting a negative relationship between board independence and

CEO compensation, which is intuitively understood through the objectivity of opinions of independent board members (see, indicatively, Uribe-Bohorquez et al., 2018). Other research findings support a positive relationship between board independence and CEO compensation, corroborating the CEO rent extraction theory proposed by Bebchuk et al. (2002); (see, indicatively, Ntim et al., 2013). The CEO rent extraction proposition questions the effectiveness of boards given their dependence on CEOs for information, which ultimately allows CEOs to receive excessive compensation in spite of board independence. A third strand of research finds no association at all between board independence and CEO compensation (see, indicatively, Mangel and Singh, 2012). We expect the analysis of Thomas Cook and the travel and leisure control group to assert the rent extraction theory. Thus our sixth set of hypotheses is:

H6a: There is a positive relationship between board independence and CEO compensation in the case of Thomas Cook.

H6b: There is positive relationship between board independence and CEO compensation in the case of the control group.

5. Data and Methodology

(i) Thomas Cook

We collect quarterly data from the annual accounts of the company and Bloomberg database for the 2008-2018 period. The variables selected are presented below in Table 1, Panel A. Descriptive statistics are given in Table 1, Panel B.

Insert Table 1

We set up our model to investigate the relationship between CEO compensation and company performance in the presence of corporate governance variables and company financials in accordance with prior literature (Jensen 1993; Yermack, 1996; Larcker et al., 2005). Our initial estimation model is:

$$LCEO_t = f(LREV_t, EBIT_t, LDEBT_t, AMEET_t, IBS_t, LZ_t, LEM_t, DIV_t, BMEET_t)$$

In such estimation problems, both OLS and two-stage least squares (2SLS) may not deliver robust standard errors. Therefore, we choose to estimate the functional relations with the Generalized Method of Moments (GMM). However, one problem with the implementation of GMM is the choice of instruments: an instrument has to be correlated with the regressors and, in addition, uncorrelated with the error term. Nonetheless, GMM is more efficient than instrumental-variable estimation, especially in the presence of heteroskedasticity. We proceed to estimate our model using the following set of instruments:

$$\mathrm{w}_t = [\mathrm{BMEET}_t, LTA_t, \mathrm{AMEET}_t, LDEBT_t, \mathrm{IBS}_t, \mathrm{DIV}_t]$$

All of these instruments are predetermined variables of our model.

(ii) Control Group:

Our control group of companies comprises panel data collected from the annual accounts of the companies and Bloomberg database during 2008-2018. Sixty-seven travel and leisure companies are selected, all listed in the London Stock Exchange. The variables studied are defined in Table 2, Panel A, and respective descriptive statistics are given in Table 2, Panel B.

Insert Table 2

Based on the literature, we set up a similar model for the panel data analysis of the control group as that used for Thomas Cook so that comparisons can be made directly:

$$LCEO_t = f(LREV_t, EBIT_t, LDEBT_t, AMEET_t, IBS_t, LZ_t, LEM_t, DIV_t, BMEET_t)$$

Next, we implement the robust Hausman test of endogeneity and we proceed to estimate our model with fixed effects using the same set of instruments stated above:

$$\mathrm{w}_{it} = [\mathrm{BMEET}_{it}, LTA_{it}, \mathrm{AMEET}_{it}, LDEBT_{it}, \mathrm{IBS}_{it}, \mathrm{DIV}_{it}]$$

Again, all of the instruments used are predetermined variables of our model, while our set of endogenous variables is as follows:

$$x_{1t} = [LEM_{it}, LZ_{it}, EBIT_{it}]$$

Our dependent variable is:

$$y = LCEO$$

6. Stylized Facts

For purposes of initial comparison at a descriptive level, we compare CEO compensation over revenues at Thomas Cook with the average CEO compensation over revenues in our control group during 2008-2018. Figure I presents Thomas Cook (red line) compared to the control group comprising sixty seven companies in the travel and leisure sector that are listed in the London Stock Exchange (blue line). The graph illustrates that CEO compensation over revenues in the case of Thomas Cook exceeded that of the control group during 2008-09 to be subsequently slashed in the troublesome years that followed. After 2011 CEO compensation at Thomas Cook recovered strongly and to exceed that of the companies comprising the control group post-2014. Regarding the control group, the spike observed in 2010 could be attributable to the high CEO turnover that characterized the hospitality industry that particular year, owing to both natural succession of CEOs and deliberate CEO replacements following the gradual recovery of the tourism sector from the 2008 recession (Kefgen, 2012).

Insert Figure I

Furthermore, we compare the incidence of earnings management at Thomas Cook with the average for the control group during the 2008-2018 period. Figure II shows a consistently higher movement of earnings management in Thomas Cook, since 2012 the year of Thomas Cook recovery. In addition, the line representing Earnings Management (red line) for Thomas Cook exceeds the sector average (blue line), indicating higher occurrence of earnings management practices in Thomas Cook than in the peer group throughout the period considered.

Insert Figure II

7. Empirical Results and Discussion

As stated earlier, the model adopted in this study is:

$$LCEO_t = f(LREV_t, EBIT_t, LDEBT_t, AMEET_t, IBS_t, LZ_t, LEM_t, DIV_t, BMEET_t)$$

As the Pearson correlation coefficient between DEBT and Z is found to be 0.82 for Thomas Cook, we estimate two models to avoid collinearity problems between variables. We present comparative regression results through 2SLS and GMM estimation in table 7a. The improvement in the significance and strength of the impact when estimating by GMM is clear. We observe that all estimates are strongly significant and have the expected signs, thereby confirming the first in each of the seven sets of hypotheses examined in this paper. In the first place, the results obtained for Thomas Cook through Model (1) confirm *Hypothesis 1a,* demonstrating a significant and quite strong inverse relationship between CEO compensation and the probability of survival of the company, which supports our argument that CEO pay played a critical detrimental role in the Thomas Cook collapse. Second, earnings management is found to have a strong direct impact on CEO compensation in the case of Thomas Cook, confirming our *Hypothesis 2a*. Moreover, the results demonstrate that board diversity, frequency of board meetings, and frequency of audit committee meetings all have a strongly significant and negative impact on the CEO compensation, in line with our *Hypotheses 3a, 4a,* and *5a*, respectively. Thus, both the presence of more women on boards and more frequent meetings of board and audit committees appears to be effective in monitoring management in general and restraining CEO pay in particular, in line with stakeholders'

interests. Additionally, our findings give a significant positive relationship between board independence and CEO compensation in the case of Thomas Cook confirming the rent extraction theory, in line with *Hypothesis 6a*. Finally, we observe the positive and strongly significant impact of profitability and company size on CEO pay, as well as the adverse impact of company debt upon CEO pay.

Insert Table 7a

In the case of the control group, we initially carry out a panel least squares estimation in order to explore the sign and significance of the coefficients derived. We continue with random effects estimation and, following the Hausman test results (Table 7c), we carry out fixed effects estimation. All panel analysis results for the control group are presented in Table 7b.

Insert Table 7b

Insert Table 7c

As in the analysis for Thomas Cook, we estimate two models and present comparative results in order to avoid collinearity problems between variables. Table 7d presents our results with two methods of estimation: Panel fixed effects with robust standard errors, and GMM with robust standard errors, which ensures instrument exogeneity by the p-value of the J-Statistic. Columns 2 and 3 in table 7c present the results of the selected estimation method. The chosen models are Model (1) and Model (2).

Insert Table 7d

It is evident from Model (1) that the probability of survival and earnings management are found to have a positive and highly significant impact on CEO pay in the control group, which is consistent with our *Hypotheses 1b and 2b*. The former is

interpreted in the context of a reward to good management practices, while the latter as recognition that the means of attracting investors to the company are successful. Furthermore, the presence of more women in the board exerts a significant and negative influence on CEO pay in line with our *Hypothesis 3b*, as board diversification adds to transparency and enhances monitoring of management practices. Also, the number of board meetings and the number of audit committee meetings have both a strongly significant and negative impact on the CEO compensation this finding is in line with our *Hypotheses 4b and 5b* for the control group since both bodies are considered to be effective in monitoring management and act in line with the stakeholders of the company, hence they are expected to control CEO pay. As regards board independence in the case of the control group, it is found to impact positively CEO compensation asserting our *Hypothesis 6b* and the rent extraction theory of CEO compensation. Our results are in agreement with those of Ozkan (2007) and Al-Najjar (2017), indicating that independent members in the board cannot effectively control management pressure. As expected, both the impact of profitability and that of company size on CEO pay are found to be direct, while leverage and CEO compensation have a negative relationship. All results on corporate governance variables and their influence on CEO pay obtained through Model (2) corroborate those obtained through Model (1).

8. Conclusions and Policy Implications

In its 178-year history, Thomas Cook changed hands several times, notably during World War II when it was nationalized, in 1972 when it was re-privatized, and in 2001 when it was acquired by the German travel giant C&N Touristic AG. Since then, it found itself at the verge of collapse several times, most recently in 2011 following an acquisitions frenzy that increased its debt immensely. In September 2019, the firm defaulted on its debt, with banks refusing to bail it out as they had done before. The result of this downfall was the loss of thousands of jobs worldwide, while travelers around the globe found themselves in desperation trying to arrange flights back to their countries. The British government had to intervene. It became apparent that the corporate governance mechanisms designed to guarantee transparency and safeguard stakeholder interests did not serve their purpose.

Our motivation for the conduct of this study was to investigate the link presumed by agency theory between executive compensation and corporate financial performance by means of a case study that permits context specific analysis. Quantifying the link of corporate governance indicators with performance and probability of survival for the firm, we fill a gap in the literature on agency theory, as the latter generally does not deal with the influence of company context on agency costs. Comparing CEO compensation in Thomas Cook to that of a control group comprising peers in the same industry, we demonstrate that the former is significantly higher than the average of other listed firms in the sector. Subsequently, our analysis focuses on depicting the extent to which the collapse of Thomas Cook is owed to excessive CEO compensation. Using GMM methodology, we analyze data for the period 2008-2018. Our results confirm that CEO

compensation exerts a negative and highly significant influence on the probability of survival of the firm, the latter proxied by Altman's Z-Score. In contrast, the association of probability of survival and CEO compensation for the control group is found to be positive. In congruence with prior research, we detect a direct association of CEO compensation and earnings management both in the case of Thomas Cook and the control group. Furthermore, we assert that corporate governance variables such as frequency of board meetings, board diversity and frequency of audit committee meetings are significantly negatively related to CEO compensation for Thomas Cook and the control group. Finally, we discover support for the rent extraction theory in the positive relationship between board independence and CEO compensation revealed both for Thomas Cook and the control group.

The results obtained from UK travel and leisure firms underline the significance of corporate governance mechanisms for CEO compensation. Our findings are important for regulators, policy makers, practitioners, and the management of firms in the tourism sector to create rules and regulations regarding the governance of firms. More specifically, it is of vital importance that firms adopt more frequent board and committee meetings, employ the creation of more diverse boards, and increase accounting transparency. It is important that the monitoring role of independent board members be clearly defined and specified in determining a CEO's compensation package, since boards comprised of independent board members in UK listed firms in the tourism industry do not successfully undertake this monitoring role.

This study points to policy recommendations that focus principally on board independence to deal with agency issues in relation to CEO pay, while further

consideration is needed for other governance mechanisms such as board meetings and diverse boards. This may be a less costly and more efficient way of minimizing excess CEO pay that has a detrimental effect on the probability of survival.

While our findings are reliable and robust, some limitations also exist. As a result of data limitations, we include a limited number of alternative corporate governance mechanisms in our analysis. Future studies may need to include more mechanisms, such as board size, the absence of CEO duality and external audit firms. Nevertheless, this study highlights the significance of governance activities within the UK tourism sector and provides a basis for other similar studies.

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Table 1: Variables Description

Panel A: Definition of variables

LTA	The natural logarithm of the Company's Total Assets
EBIT	EBITDA
AMEET	The frequency of audit committee meetings
IBS	The percentage of independent members of the board over the total number of board members
LCEO	The natural logarithm of CEO compensation
LDEBT	The natural logarithm of debt over assets
BMEET	The frequency of board meetings
DIV	The percentage of women in the board of directors
LEM	The natural logarithm of discretionary current accruals based on the Modified Jones Model
LZ	The natural logarithm of the company's Altman's Z-Score

Panel B: Descriptive Statistics

	LREV	LDEBT	LCEO	EBIT	IBS	DIV	LZ	AMEET	LEM	BMEET	LTA
Mean	9.08	-0.16	6.37	510.49	5.68	25	1.054	5.56	-0.142	7	8.78
Median	9.10	-0.08	6.53	515.90	6.00	33	1.052	5.00	-0.56	8	8.79
Max	9.19	-0.04	6.79	556.00	7.00	44	1.277	12.00	5.48	10	8.89
Min	8.94	-0.34	4.77	412.00	1.00	0.00	0.754	3.77	-9.54	1	8.65
Std. Dev.	0.08	0.12	0.46	36.746	0.11	17	0.160	2.14	3.67	1.6	0.07

Table 2: Description of Variables

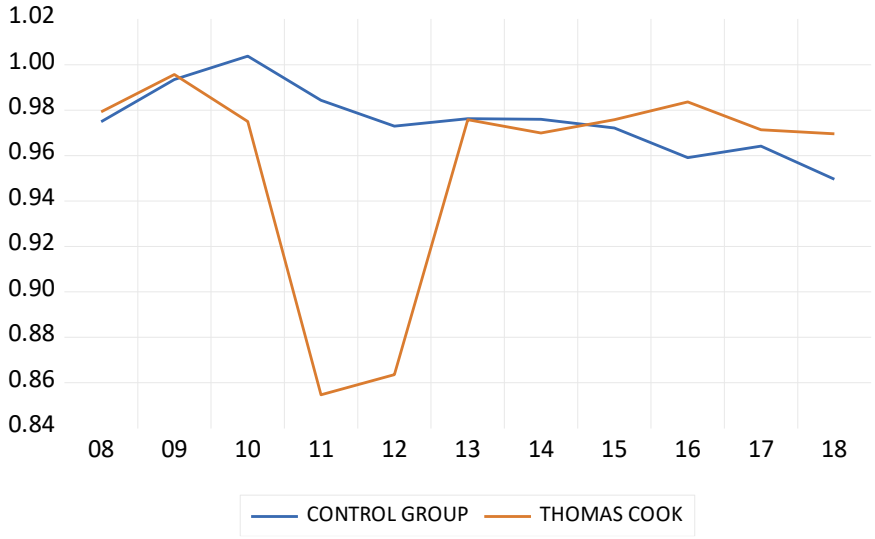
Panel A: Definition of variables

LTA	The natural logarithm of the Company's Total Assets
EBIT	EBITDA
AMEET	The frequency of audit committee meetings
IBS	The percentage of independent members of the board over the total number of board members
LCEO	The natural logarithm of CEO compensation
LDEBT	The natural logarithm of debt over assets
BMEET	The frequency of board meetings
DIV	The percentage of women in the board of directors
LEM	The natural logarithm of discretionary current accruals based on the Modified Jones Model
LZ	The natural logarithm of the company's Altman's Z-Score

Panel B: Descriptive Statistics

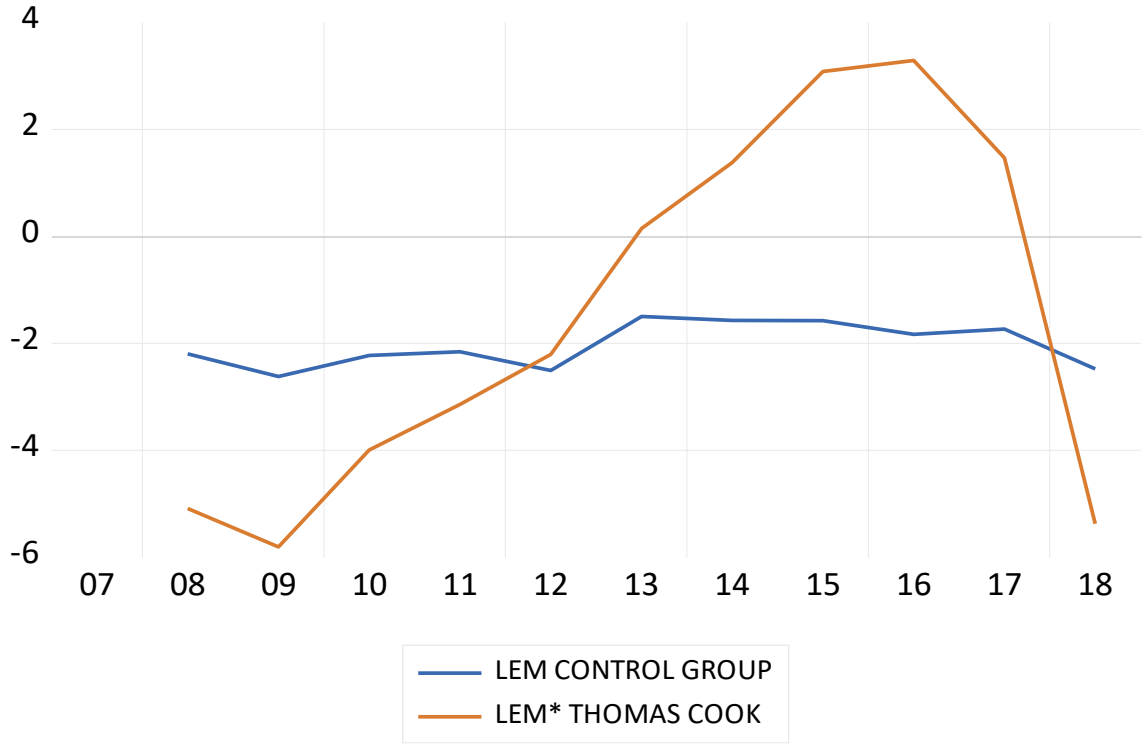
	LREV	LDEBT	LCEO	EBIT	IBS	DIV	LZ	AMEET	LEM	BMEET	LTA
Mean	5.409	-0.493	13.903	453.419	5.786	16.534	1.124	4.432	-2.035	8.978	5.520
Median	5.587	-0.419	13.824	184.575	6.000	15.000	0.996	4.000	-3.579	8.000	5.766
Max	10.096	0.359	15.333	3751.00	10.000	50.000	5.149	15.000	8.963	19.000	10.655
Min	-3.097	-2.224	12.822	-196.20	2.000	0.000	-1.801	1.000	-7.158	1.000	-2.302
Std. Dev.	2.602	0.393	0.542	707.984	1.865	11.025	0.814	2.389	4.172	2.934	2.591

Figure I. Comparison of the Ratio, CEO Compensation over Revenue



Source: Company Annual Reports

Figure II. Comparison of Thomas Cook EM (Earnings Management) with the Control Group



Source: Company Annual Reports,

*Natural Logarithm of Earnings Management

Table 7a. Thomas Cook: Determinants of CEO Compensation

	Dep. Variable: LCEO		**Dep. Variable: LCEO**	
	2SLS Model (1)	**GMM Model (1)**	**2SLS Model(2)**	**GMM Model(2)**
Constant	-6.776 (16.052)	-15.777** (6.698)	-2.743 (7.952)	-3.206 (3.035)
LTA	3.000 (1.998)	4.072*** (0.861)	1.199 (0.946)	1.226*** (0.357)
EBITDA	-	-	0.003*** (0.001)	0.003*** (0.0006)
AMEET	-1.180*** (0.112)	-1.170*** (0.064)	-0.086** (0.039)	-0.067*** (0.013)
IBS	0.252** (0.085)	0.226*** (0.044)	0.166*** (0.055)	0.128*** (0.033)
LEM	0.204 (0.152)	0.141** (0.021)		-
LZ	-1.829** (0.666)	-1.550*** (0.292)		-
LDEBT	-	-	-1.293 (2.676)	-2.071** (1.068)
BMEET	-0.486** (0.228)	-0.554*** (0.127)	-0.336*** (0.050)	-0.318*** (0.028)
DIV	-1.237*** (0.110)	-1.227*** (0.057)	-0.444** (0.245)	-0.326** (0.095)
Prob(J-Statistic)	**0.035**	**0.345**	**0.046**	**0.170**

Notes: Numbers in brackets are standard errors.

*** Indicates significance at 1% level. ** Indicates significance at 5% level. * Indicates significance at 10% level.

Table 7b. Control Group: Determinants of CEO Compensation

Dependent Variable: LCEO			
	Panel Least Squares	**Panel Random Effects**	**Panel Fixed Effects**
Constant	12.406*** (0.365)	11.501*** (0.424)	8.478*** (0.867)
IBS	0.078*** (0.026)	0.075*** (0.026)	0.088** (0.037)
BMEET	-0.051*** (0.011)	-0.025*** (0.010)	-0.022* (0.012)
EBIT	0.0002** (0.000)	0.000 (0.000)	0.000 (0.000)
LDEBT	-0.194** (0.095)	-0.070 (0.098)	0.142 (0.119)
LTA	0.149*** (0.048)	0.258*** (0.056)	0.697*** (0.107)
DIV	-0.004 (0.003)	-0.002 (0.003)	-0.068*** (0.019)
AMEET	0.060* (0.033)	0.034 (0.029)	0.002 (0.032)
LZ	0.252*** (0.064)	0.334*** (0.078)	0.499*** (0.126)
LEM	0.006 (0.007)	-0.004 (0.005)	0.0004 (0.005)
R^2	0.61	0.42	0.86

Notes: Numbers in brackets are standard errors.

*** Indicates significance at 1% level. ** Indicates significance at 5% level. * Indicates significance at 10% level.

Table 7c. Hausman specification test for panel analysis of the Control Group

Specification Test	Chi-Squared	D. F.	P value
FE vs RE	42.723	10	0.0000

Table 7d. Control Group:

Panel Fixed Effects and GMM with robust standard errors

	Panel Fixed Effects	**GMM Model (1)**	**GMM Model (2)**
Constant	8.794*** (0.457)	11.661*** (0.067)	13.849*** (0.178)
IBS	0.097*** (0.019)	0.063*** (0.003)	0.105*** (0.006)
BMEET	-0.099*** (0.011)	-0.103*** (0.003)	-0.118*** (0.005)
EBIT	0.000 (0.000)	-	0.0003*** (0.000)
LDEBT	0.035 (0.112)	-	-0.333 (0.014)
LTA	0.658*** (0.078)	0.337*** (0.007)	0.063*** (0.022)
DIV	-0.066*** (0.012)	-0.006*** (0.001)	-0.002** (0.001)
AMEET	-0.027 (0.017)	-0.034*** (0.004)	-0.029*** (0.005)
LZ	0.512*** (0.061)	0.505*** (0.017)	-
LEM	-0.002 (0.002)	0.024*** (0.003)	-
R^2	0.85		
J-stat(p-value)		0.610	0.526

Notes: Numbers in brackets are standard errors.

*** Indicates significance at 1% level. ** Indicates significance at 5% level. * Indicates significance at 10% level.

ENDNOTES

[i] The timeline of events in the history of Thomas Cook is based on information published on the company's website and the press, mainly *The Guardian*.

[ii] Although deliberate inflation of company earnings distorts the quality of firm financial statements causing agency issues, the tendency of past profits to be positively associated with future profits implies a positive relationship between earnings management and firm profitability making earnings management practices likely (Fama and French, 2000).