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## Related Party Transactions and Earnings Management

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### Abstract

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This study reviewed some studies conducted on related party transactions and earnings management. Based on agency theory, agency conflict motivates managers to engage in self-enrichment transactions at the expense of the owners of the firm. Management or concentrated ownership is proposed to deal with this type of agency problem. However, this form of ownership structure came with its problem that give rise to type II agency conflict between controlling owners and minority shareholders. Controlling shareholders use their controlling power to benefit from the insider information and engage in prejudicial related party transactions at the expense of minority shareholders. This paper identified how and why managers or controlling shareholders use related party transaction as a convenient means to perpetrate accrual-based or real activity earnings management. It was recommended that empirical study be conducted to investigate whether disclosure regulation can constrain real-activity management through related party transaction.

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**Keywords:** Related party transactions; accrual-based earnings management; activity-based earnings management; tunnelling, propping.

### 1. Main text

Related party transactions (RPTs) have been subject to academics and regulators scrutiny for the dual roles it plays on the firms operations. It is used for both value-generation and value-destroying purposes. The extent of literature has documented mixed results on the effects of RPTs on firms operations in particular and the quality of its reported earnings in general. Several studies have revealed the positive aspects of RPTs within the value generation process of a firm (Jian & Wong, 2010; Loon & Ramos, 2009; Munir, Saleh, Jaffar, & Yatim, 2013). These benefits include reduced transaction cost,

efficient resource generation and allocation through internal market within the group, and sustenance of important but less profitable business units (Loon & Ramos, 2009). In contrast, some studies argued that RPTs are used by insiders (controlling shareholders and management) as a vehicle for firm expropriation (Munir et al., 2013; Mustafa, Abdul Latif, & Taliyang, 2011). However, Jian and Wong (2010), and Liu and Lu(2003) have argued that the main motive behind RPTs is for earnings management purpose.

Several studies have documented empirical evidence that firm engages in RPTs for tunneling purposes (Du, He, & Yuen, 2013; Jiang, Rao, & Yue, 2014), while others provide evidence that some transactions are initiated to prop the financially distressed firms (Gonenc & Hermes, 2008; Ying & Wang, 2013). Some firms may even engage into fictitious RPTs in order to meet a targeted profits as it happened in the famous case of Enron. In any case, whether it is tunneling, propping or fabricated, RPTs affect the quality of the firm's reported earnings. Earnings is said to be of high quality if it is free from management bias and display the actual results of operations. This paper conceptually investigates how RPTs are used through both accrual and real activities to manage the reported earnings.

## **2. Related party transactions**

Related party transaction has been defined as any transaction that consist of transfer of resources, services or obligations between reporting entity and its related parties without due regards to whether consideration is charged or not (IASB, 2005). IASB defines related party to include board members, major shareholders, key management personnel and any other party with significant influence over the affairs of an entity. Nekhili and Cherif (2011) defined RPTs as a transaction between reporting entity and any other party that relates to it such as subsidiaries, board members, managers, controlling shareholders, joint controlled firms, associates firms and alike. These forms of transactions are widespread across the globe (Jiang, Lee, & Yue, 2010; Lin, Liu, & Keng, 2010) and more frequent in countries with concentrated ownership (Munir et al., 2013) or countries with weak investors' protection (Ma, Ma, & Tian, 2013).

Based on agency theory, management (agent) may not act in the best interest of their principal (shareholders). Managers may resort to opportunistic behavior that will amount to self-enrichment at the detriment of the owners of the firm (Shleifer & Vishny, 1997). In order to curtail this menace, shareholders engage into number of activities ranging from increasing the welfare of management staff, instituting good corporate governance and bounding the interest of management with that of the firm. The total cost of carrying out these strategies is termed as agency cost (Jensen & Meckling, 1976). Jensen and Meckling (1976) argued that high managerial ownership can mitigate this form of agency problem. Similarly, Shleifer and Vishny (1997) believed that the presence of controlling shareholder monitor the management conduct in a firm.

It must be noted however that the presence of controlling shareholders has its-own associated costs, as they may decide to engage into insider dealings at the expense of minority shareholders. This form of agency problem (principal-principal) is termed as type II agency problem (Du et al., 2013; Fernando, Schneible, & Suh, 2013; Nekhili & Cherif, 2011). Companies with concentrated ownership

are more likely to be tunneled as a result of conflict of interest between controlling and minority shareholders. Du et al. (2013) cautioned that in the case of the presence of concentrated ownership, even good legal and strong investor protection cannot completely prevent minority shareholders from been expropriated by insiders. This can be related to some cases of some corporate governance breaches in some developed nations. Several studies provide evidence that controlling shareholders cannot be exonerated from insider dealings. Kali and Sarkar (2011) have found that the main motive behind firm diversification in an emerging economy is for tunneling purposes. Similarly, Wang and Xiao (2011) documented that controlling shareholders cannot enforce the pay-performance compensation scheme if they involved in tunneling activities.

It must be noted however, that during the period financial difficulties, controlling shareholders may opt to bailout their listed firms. The act of injecting personal money into publicly quoted firm is termed as propping (Friedman, Friedman, & Johnson, 2003). Propping is usually done to meet regulatory threshold, induce potential investors or improve the financial position of a distressed firm (Peng, Wei, & Yang, 2011; Ying & Wang, 2013). Propping activities have been supported by the theory of market for corporate control (Jensen & Ruback, 1983). In many instances, controlling shareholders uses related party sales to prop up their firms (Jian & Wong, 2010) to avoid the overwhelming market reaction in reporting small loss. In any way, whatever decision taken by firm to manipulate the reported figure can be seen as unethical behavior even if it is within the boundary of law (Johari, Saleh, Jaffar, & Hassan, 2008) as it is going to affect the quality of reported earnings.

### **3. RPTs and Earnings Management**

Earnings management has been described as a situation where managers use available accounting judgments to structure transaction in a manner that misrepresent the true economic position of the firm with the intention to influence the outcomes of contractual agreements that are based on reported accounting numbers. Managers have different incentives to engage in earnings management practices ranging from beating analysts forecast, avoidance of small profit, maintenance of existing performance, and circumvent of capital market regulatory requirements among others (Chen, Lee, & Li, 2008; Roychowdhury, 2006).

Firms that are members of business group and government-link firms were identified to engage in earnings management more than their stand-alone counterpart. This is connected with the nature of their ownership structure and the volume of transactions conducted with their related firms. Numerous firms engaged into earnings management practices to hide prejudicial transactions by the controlling shareholders. Firm manage reported earnings through accrual-based management method and non-operating RPTs (Ding, Zhang, & Zhang, 2007). Aharony, Wang and Yuan (2010) have found that many firms use RPTs to improve their financial position during pre-initial public offering (IPO) period. The authors documented that related party sales are used by initial public offering firms with their holding firm to inflate their reported earnings in such a way that deceptively increase their return on assets. Even though these transactions have actually benefitted propped firm, Ying and Wang (2013) have reported that in most cases the practice is followed by excessive tunneling by controlling shareholders to wipeout the imported profit from the those firms.

Similarly, Hwang, Chiou and Wang (2013) believed that most of the transactions with offshore related parties are arranged to provide insiders with opportunity to engage in earnings management. In the same vein, Beuselinck and Deloof (2014) have revealed that business group firms manage earnings more than non-business group firms. They found that the earnings management is severe in wholly owned subsidiaries compared to subsidiaries with minority interest. This finding reaffirms the position of Satkunasingam and Shanmugam (2006) that minority shareholders watchdog group does not play their responsibilities accordingly, but the group has a potential on constraining the negative effect of controlling shareholders in the future.

Chen et al. (2008) have found that government-linked firms are supported by their respective holding governments to involve in earnings management. This is done usually to maintain the listing status or get access to fresh financing fund through rights offering. Recently, He, Mao, Rui and Zha (2013) have found that state-owned firms used internal transaction arrangement as an alternative to external market to cater for their financing needs and share the overall business risk among all affiliated firms. These practices are clear evidence that the reported figure of such associated firms are influenced by their group decisions and may not portrays the actual under-lying economic position of the reporting firm.

#### **4. Types of Earnings Management**

The extent literature have identified two major forms of earnings management, namely accrual-based and real-activities earnings managements (Cupertino, Martinez, & da Costa Jr, 2015; Gunny, 2010).

##### *4.1 Accrual-Based Earnings Management*

Accrual-based earnings management method employed the use of accounting judgment and methods to manipulate the reported figure. Healy and Wahlen (1999) identified some of the strategies in accrual method to include managements in inventory valuation method, bad debt estimation, revenue recognition or change in the firm depreciation policy. It is important to note that accrual method does not affect the cash flow or cash position of the reporting firm, it rather deal with mostly with non-cash expenses to alter the magnitude of reported earnings. The most commonly used tool in measuring accrual-based management is the modified Jones model by Dechow, Sloan and Sweeney (1995). Under this approach, total accruals (as determine by subtracting operating cash flow from operating profit) are disintegrated into discretionary and non-discretionary components. Discretionary accruals are used as proxies for earnings management because of the extent of managerial judgment attached to it.

Qiao Liu and Lu (2003) provide empirical evidence that controlling shareholders use discretionary accruals for tunneling purposes. They went further to trace the origin of earnings management among the Chinese firm to the rivalry between controlling and minority shareholders. Similarly, Ding et al. (2007) have found that RPTs are used to conduct or compliment operation-related accrual management. Recently, Hwang et al. (2013) admit that firms manipulate earnings through discretionary accruals using RPTs. However, they found that disclosure regulations have mitigated the extent of the practices.

#### 4.2 Real-Activities Earnings Management

Unlike accrual-based earnings management, real-activities earnings management involves controlling operational activities to deter the activities from manifesting what they would have been if not controlled, which effect both cash and reported earnings of the firm (Cohen & Zarowin, 2010; Roychowdhury, 2006). It is usually employed to increase short-term profitability of the firm other than building long-term sustainability or value (Zang, 2012). Real-earnings management covers strategies such as cutting research and development expenditure, management of transfer pricing, lax credit terms, cutting selling, general and admin expenses, changes in discount policies and many more (Cohen & Zarowin, 2010; Kuo, Ning, & Song, 2014; Roychowdhury, 2006). The effect of real-activity management on firm is more severe compared to accrual management. This is based on the fact that the cost of the former is real and in most cases irrecoverable. Real-activities management has gotten prominence among managers as a result of lean knowledge of it by both regulators and investors and tied regulations that exposes accrual management (Gunny, 2010). Roychowdhury (2006) have adopted and modified (Dechow, Kothari, & Watts, 1998) model to capture real-activity managements. The model has gain prominence among the earnings management studies as it is widely used in subsequent literatures. It has taken care of possible management of earnings through over-production to cut production cost, cash flow managements through timing of financing and investing activities or management of the extent or frequency of operating activities.

Cheung, Qi, Rau and Stouraitis(2009) provide empirical evidence on how firm engages related parties at hostile price compared to similar transaction conducted at arm's length position. They argued that firm pays exorbitant price to acquire assets from their related parties and receives less if the consideration is compared to open market negotiation. Similarly Jian and Wong(2004), and Williams and Taylor(2013) have found that firms use abnormal related party sales to increase their return on equity in order to avoid been categorized as special treatment firms. In a related development, (Abdul Latif, 2010) finds that among others managers engage in share buyback for entrenchment and earnings (EPS) purposes. These findings are supported by more recent studies. Burnett, Cripe, Martinand McAllister(2012) investigated the motive behind accretive stock repurchases and found that managers use self-transaction to manage earnings per share through accretive repurchase to meet analysts forecast.

#### 5. Conclusion and Recommendation for Future Studies

In this study we have discussed how related party transactions are used for both value-generation and value-destroying purposes. The paper detailed-out how tunneling and propping are perpetrated through the use of related party. Furthermore, it was established that managers have been using RPTs via accrual managements to manage the reported earnings. With the tied regulations and detail disclosure requirement, the use of real-activities managements becomes the order of the day by managers as a substitute or compliment to accrual earnings management. The study also discovers that both methods of earnings management can be affected conveniently with the aid of related party transactions. In view of this, this study recommends that empirical study be conducted to identify whether disclosure regulation will constrain real-activity management. It also recommends that

auditors should be asking to pay much attention on the tendencies of real-activity management through RPTs and report the outcome to the shareholders.

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