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Managing Related Party Transactions on Earnings Quality

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Abstract
The quality of earnings reported in the financial statement is very vital as it will be the key characteristic to improve capital market efficiency. Prior researchers indicate that the Earnings Quality were affected by several factors such as analysts forecast, leverage requirements, and management opportunities. One of the crucial factors in determining Earnings Quality is Related Party Transactions. It has been used as a medium in committing fraud across the corporate world for the last 20 years. The key problem affiliated to Related Party Transactions is that the transactions are influenced by the relationship between parties involved in the transactions. Among the transactions between related parties are purchase and sale of properties (assets), and sale of goods. Earnings reported in the financial statements is said to be high quality when the reported earnings are free from management prejudice and show the actual results of operations. This paper provides a holistic view of the concept of Related Party Transactions and Earnings Quality. The second purpose is to provide a better understanding of the relationship between Related Party Transactions and Earnings Quality. The discussion of this study will provide suggestions for improvements in corporate culture.

Keywords: Related Party Transactions, Earnings Quality, Corporate Scandals, Agency Theory

Introduction
Related Party Transactions (RPTs) are reflected as a common business activity and a large volume of such transactions is restricted in firms without the commitment of accounting and financial fraud (Gordon, Henry, Louwers and Reed, 2007). The 1997/98 Asian Financial Crisis (AFC) has brought forth a generally accepted view that RPTs in the Asian region are unmannerly in nature (Mohamad Ariff and Hashim, 2013). There are three reasons behind these allegations. First of all,
significant risks of abusive RPTs exist whenever the controlling shareholder own private interests outside of the listed company, such as in Asia. Secondly, the controlling shareholders have ample opportunity to take advantage of the liquidation of company’s assets (Mohamad Ariff and Hashim, 2013). Finally, the perpetual practice of abusive RPTs can be linked to incompatible law and legal enforcement in East Asian countries that inadvertently protects controlling shareholders from accountability. In a nutshell, the laws and regulations in East Asian countries were ill-equipped to mitigate the issues surrounding the RPTs. These theories are proven through multiple instances of frauds involving RPTs in those countries; for example, Genting Malaysia Berhad in Malaysia, Sinar MasGroup of the Widjaja family in Indonesia, Rebar Group in Chinese Taipei, Hong Kong-listed Kelon Electrical Holdings Company and Pacific Challenge Capital (CFA Institute, 2009; and Mohamad Ariff and Hashim, 2014). If left unchecked, the malpractice of RPTs can potentially lead to value-destroying transactions such as tunnelling (Du, He & Yuen, 2013; Jian, Rao & Yue, 2014) and squeeze-outs (Khanna, 2015). Furthermore, RPTs also have been used to manage earnings (Jian & Wong, 2010; Liu and Lu, 2003) for financial reporting and tax purposes (Lo and Wong, 2011).

In recent years, the earnings quality has been questioned (Schulzke, 2016). Earnings quality (EQ) is vital for every company as low earnings quality will cause a company to be unable to estimate its ability to pay debt and to pay dividends to shareholders (Bharath, Sunder & Sunder, 2008). According to Bhattacharya, Daouk and Welker (2003), Malaysia is one of the countries in the world with the most aggressive earnings. Among the countries with the worst Earnings Management ratings are Malaysia, Hong Kong, and Singapore (Leuz, Nanda and Wysocki, 2003). The latest case in Malaysia took place in 2010 that brought Inix Technologies Bhd to the limelight. This shows that the quality of earnings of most companies in Malaysia is still not improving. Prior to the Asian Financial Crisis (AFC) in 1997/98 and the infamous financial scandal for which Enron and Arthur Andersen were a part of, managers were known to engaged in accrual-based activities. However, the post-AFC and Enron cases era brought forward a paradigm shift where managers prefer to engage with real-based activities (Cohen et al., 2010). Ewert & Wagenhofer (2005) reported that the level of Real Earnings Management (REM) increases after accounting standards were strengthened and this finding was further supported by Cohen et al. (2010). In the United States, firms switched from AEM to REM post-SOX (Ho and Sung, 2012). This evidence suggests that regulations on accrual-based earnings management have been tightened which leads to a greater use of REM.

This study will explore the issues surrounding related party transactions together with earnings quality and the impact of these two components. The rest of this paper is organised according to the following order; literature review, discussion on related party transactions, earnings quality and their implication, and conclusion.

Background
Several fraud cases on Related Party Transaction (RPTs) such as Enron and WorldCom in the United States of America; Genting Bhd in Malaysia; Sinar MasGroup of the Widjaja family in Indonesia; and Satyam in India (to name a few) have brought the attention of all parties to be more alert on the disclosure and presentation of RPTs in their financial statement. While a number of mechanisms have been introduced to monitor RPTs, abusive RPTs are still pervasive (Nor and Ismail, 2015). Since the Asian Financial Crisis (AFC) in 1997/98, reforms to the law and
regulation systems have been instilled in Asian countries, including Malaysia in order to curb abusive RPTs (Nor & Ismail, 2015). Among them are Malaysia Code of Corporate Governance (MCCG) and Bursa Malaysia Listing Requirements (BMLR). The problems surrounding the Related Party Transactions (RPTs) benefits the top management and controlling shareholders the most. A major area of concern with regard to this issue is the effect of Related Party Transactions on the earnings quality (Ariff and Hashim, 2013; Rahmat, 2013).

Malaysia has finally adopted the IFRS24 on Related Party Disclosures which became our own standard with the namesake MFRS 124: Related Party Disclosures. While the new standard focus on the definition of related party transactions and disclosures of government-related entities, it also simplifies the definition of RPTs. Previously, all government-related entities were exempted from disclosing their related party transactions in their annual report. The standard is applicable for annual periods beginning on or after the 1st of January 2012. This is important to scrutiny the effectiveness of the new standard on related party disclosures as it will give different perspectives on its impact towards earnings quality. Previous researchers have focused on the related party transactions prior to the introduction of the standard. Therefore, this study doubles as an opportunity to fill up the gap in the timeline prior to the implementation of the new standard.

In the beginning of January 2006, all of Malaysia’s listed firms were required to adhere to the reporting standards of International Financial Reporting Standards (IFRS) in preparing their financial statements (Lau, 2010). The ultimate aim of this requirement is to harmonize the corporate accounting practice and to achieve high-quality standards that can be implemented in international major capital markets. The new IFRS strives to tighten the rules on accrual-based management activities, a move which has encourage managers to move to real-based management activities (Kalgo, 2015).

Following the adoption of International Financial Reporting Standards (IFRS), researches have been done to determine the impact of IFRS on the quality of earnings. The inconclusive results were empirically obtained from this relationship (Amidu, Yorke & Harvey, 2016). Some countries that adopted IFRS saw improvements in their accounting information quality (Meeks and Swann, 2009; Chen et al., 2010; Chua et al., 2012); others reported no significant improvement in reporting quality (Kao and Wei, 2014); while others found that earnings quality deteriorated when they adopted IFRS (Jeanjean and Stolowy, 2008). Another stream of research finds that earnings quality improved but other factors could contribute to the improvement besides the adoption of the standards (Barth et al., 2006; Soderstrom and Sun, 2007). These discrepancies could be rooted in the interactions between political and institutional environment in which the business operates and the firm specific characteristics of sampled firms in the study (Ball, 2006). While the quality of earnings can be improved through the adoption of IFRS, other contributing factors need to be taken into the overall picture as well. This study is based on this on-going argument and expects that were IFRS has a positive impact on earnings quality, it means that managers will have less opportunity to manipulate earnings; henceforth, earnings management is anticipated to lessen (Amidu, Yorke & Harvey, 2016).
The issues of related party transactions and earnings quality are closely related with Agency Theory which demystifies human behaviour in the firm, specifically the relationships between one party to another party. In other words, the principal or owners of the firm will delegate some decision-making authority to another party, known as the agent (Jensen & Meckling, 1976). This relationship is akin to a well-defined line that exists between the management and ownership, in which firms are managed by people who do not own the firm (Rahmat, 2013). This is common for most businesses as the owner will appoint managers who have minimal shareholdings within the firm which in turn minimizes the owner’s participation in day-to-day operations (Rahmat, 2013). Based on the agency theory, RPTs will reduce the earnings quality of firms. The transactions between related parties are said to be in favour of the related persons, not for the company as a whole.

This study will use the Agency Theory which is the most relevant theory for this study. It covers two parts; Agency Theory Type I and Agency Theory Type II. Agency Theory Type I is between shareholders and the managers; while Agency Theory Type II is between shareholders and other shareholders. Agency Theory Type I is well known among researchers. Agency cost between shareholders and managers will be eliminated because there is a minimum classic shareholder-manager agency problem as there is an obvious existence of ownership and control i.e the separation of ownership and control (Jensen and Meckling, 1976; Fama and Jensen, 1983a). Nevertheless, agency problems could also be minimized when managers keep their distance from the controlling shareholders which permits the shareholders to closely monitor the activities of the managers (Shleifer and Vishny, 1986; Villalonga and Amit, 2006).

Nonetheless, according to Anderson & Reeb (2003) and Villalonga & Amit (2006), the conflicts between majority and minority shareholders happen because the majority shareholders have a tendency to focus on amplifying their returns rather than thinking about other investors; i.e minority shareholders (Shleifer and Vishny, 1997). This is known as Agency Theory Type II. The level of Agency Cost Type I could be lower compared to type II; but, both types could exist in the firm (Vilalonga and Amit, 2006). Agency Cost Type II can become worst when there is a huge incentive; while, the huge incentives can monitoring the Agency Cost Type I (Ali et al., 2007).

**Related Party Transactions**

Related party transactions (RPTs) are best known as the transmission of resources, services, or obligations between a reporting entity and a related party, notwithstanding of whether a price is charged or not. This definition comes from Malaysian Financial Reporting Standard (MFRS) 124. Meanwhile, previous researchers have defined Related Party Transactions (RPTs) as transactions between a company and related entities; for instance, affiliates, subsidiaries, directors, officers and principal owners (Gordon, Henry, Louwers and Reed, 2007). Firms are required to make an immediate announcement to the exchange of Related Party Transactions (RPTs) and need to provide relevant information as prescribed by Section 10.08, Part E in Chapter 10 of Bursa Malaysia Listing Requirement (BMLR). Para 2 of Section 10.08 also mentioned that the shareholders need to give their approval at the extraordinary general meeting through a circular if the firm exceeds 5% of any of the percentage ratios.
In Malaysia, RPTs is a common practice in business. The symbiosis of cultural and political influences in Malaysia has led to the practices of RPTs. Generally, RPTs are commonplace in Malaysia, in which specifically based from the perspective of investors (Ariff and Hashim, 2013). However, RPTs in the Asian region are viewed as abusive in nature during the 1997 Asian financial crisis. Among the infamous fraud scandals in Malaysia which involved RPTs are Genting Bhd and Tradewinds (M) Bhd. According to Munir et al. (2013), there will be an expropriation to minority shareholders due to RPTs because of weak investor protection laws and the lack of shareholder activism. Even Malaysia follow the highly regarded legal system in the world which is English common law; nevertheless, there is still in weak enforcement of such laws (Ball et al.,2003; Leuz et al., 2003).

The main concern of RPTs is whether this issue will put businesses in a bad light as RPTs have resulted in substantial wealth loss to the shareholders when the transactions may not be conducted in an arm’s length. RPTs have attracted particular interest because of the predominance of family business structures where RPTs are commonplace (Khanna, 2015). (RPTs) of a company are transactions between the company and a person related to the business such as a subsidiary, large shareholders, directors, executives or their relatives (or business organisations controlled by any of them). RPTs have potentials to be problematic because they can lead to value-destroying transactions such as tunneling and squeeze-outs (Khanna, 2015). However, not all RPTs are bad. Some RPTs can be value-enhancing in the sense that such transactions may represent the best deal that can be struck, for instance; a director of a company may run his/her own business which has RPTs, but it is likely to be value enhancing.

A study by Gordon, Henry and Palia (2004b) found that RPTs are sound business exchanges that fulfill the economic needs of the firm. It is based on the efficient transaction hypothesis. Indeed, research can be valuable in emerging markets in which they can help to lessen the bankruptcy risk faced by some group firms and may assist in capital raising (Lincoln, Gerlach and Ahmaddijan, 1996; and Khanna and Yafeh, 2007). In contrast, RPTs are economically harmful to the firm based on the principal-agency conflicts theory by Berle and Means (1932). The firms’ resources can be potentially expropriated and can inflict significant dents to the shareholders’ wealth which is instigated by the conflict of interest that is contaminated by RPTs.

Earnings Quality
Ewert & Wagenhofer (2010) have stated that in order to improve capital market efficiency, having a sound earnings quality is imperative as it is the most important characteristic in financial statements. Nevertheless, there is no particular standard that defines earnings quality as it depends on many features. Even if there is no clear definition of earnings quality, Financial Accounting Standard Board (FASB) has a common framework on a number of qualitative characteristics that should be achieved in order to have a high quality of financial report such as comparability, faithful representation, relevance, timeliness, understandability and verifiability (Ewert & Wagenhofer, 2010). If these qualitative characteristics are not well-managed, the quality and credibility of the reported earnings are questionable. Meanwhile, Dechow and Schrand (2004) defined earnings quality as a degree that shows how well the reported earnings can imitate the actual value.
Earnings quality is best represented by earnings management (Dechow et al., 2010). The issue of earnings management (EM) is not new in the accounting circle. Accounting manipulation activities have been around since the 1970s and the issue is still rampant today. EM is legally accepted as it is within the General Accepted of Accounting Procedures (GAAP). It comprises of two elements, namely, Accrual Earnings Management (AEM) and Real Earnings Management (REM). Although there are no explicit definitions of EM, there have been various definitions of it in past literature. A good definition of EM is from Healy and Wahlen (1999). According to them:

“Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic value of the company or to influence contractual outcomes that depend on reported accounting numbers.” (Healy & Wahlen, 1999, p.368).

From this definition, it can be said that EM is a purposeful act and there are cases where managers go out of their way to manipulate the accounting numbers. This is done to convey the idea that the financial statements are in good position so that the stakeholders will invest more in the company and will not take away their investments to other places.

AEM involves the GAAP choices that try to obscure or mask the true value (Dechow & Skinner, 2000). AEM involves managers’ discretion within the GAAP choices. In contrast, REM occurs when managers undertake actions that deviate from the best practice to increase the reported earnings. Both are legally accepted within the law. However; REM is less likely to be detected by regulators, analysts or auditors (Graham et al., 2005). According to Brown (2011), firms which engaged in income smoothing or made larger accruals adjustment when calculating net income or even has used less conservative accounting practices will have lower quality earnings. In German firms, IFRS is found to be unable to constrain the Earnings Management (EM) compared to German GAAP; where companies that did not adopt IFRS have the tendency to engaged in more income smoothing although the effect was not as apparent among firms with a Big 4 auditor (Tendeloo & Vanstraalen, 2005). Goncharov and Zimmermann (2006) indicate that new IFRS did not improve the accounting quality in German as compared to German GAAP.

However, there was a study which found that IFRS has at least reduced the EM in Central European countries, although changes were nonexistent for companies in the UK, Ireland or Northern Europe (Aussenegg et al., 2008). Another study found that IFRS has improved the accounting quality for a sample drawn from 21 countries, in the sense that there were less EM activities engaged by the firms and more timely loss recognition (Barth et al., 2008). In short, not all studies have reached the same conclusion. Different proxies and different samples for earnings quality must untangle the confusion in the existing literature (Brown, 2011).

**The Effects of Related Party Transactions on Earnings Quality**

Prior researches have explored the connection between Related Party Transactions (RPTs) and expropriation of firms’ resources by controlling shareholders or so-called majority shareholders. They found an association between expropriation and RPTs (Djankov et al., 2008; Johnson et al., 2000) and these evidence are consistent with the argument that managers can manage reported
earnings by structuring RPTs (Healy and Wahlen, 1999). Djankov et al. (2008) provide evidence that RPTs can give managers and controlling shareholders incentives to expropriate minority shareholders through tunneling activities. RPTs can also be used to manage earnings upwards to avoid reporting losses (Friedman et al., 2003). In other words, the controlling shareholders will get the benefits from RPTs at the expense of minority shareholders. Several studies have investigated the consequences of RPTs and found that they are associated with negative firm valuation effects (Djankov et al., 2008; Johnson et al., 2000; Gordon and Henry, 2005; Cheung et al., 2006). This means that the value of the firm will be affected by the activities from RPTs. This statement is supported by the downfall of giant companies such as Adelphia, Conrad Black’s corporate group, Hollinger and the Riga family’s corporate group (Ge et al., 2010). These corporate scandals raised a question of whether RPTs are associated with lower accounting quality for reporting firms or otherwise.

However, Gordon and Henry (2005) found that RPTs could be more effective than engaging with a related party because it is guaranteed to the company and there would be less incentive for the company to manage earnings. There are several potential benefits of these transactions, namely, the aptitude to alleviate external market failure from access to these internal institutions (Khanna and Palepu, 2000). It arises as the cost for emerging market firms to acquire the necessary inputs, such as finance, technology and management talent is higher due to the nonappearance of intermediary institutions. It is supported by Chang and Hong (2000) in which they found that the internal capital market of business groups’ supplement and inefficient external market and the vertical integration within a group allows it to share technological resources as well as lessen transaction costs.

Based on the study done by Antonios et al. (2011), they found that the firm value is reduced when the firm sold goods or assets to related parties in Greece (a develop country) rather than sold it off to non-related parties. This is not experimental for RPTs came into effect in Greece in 2005 after a new fair value measurement rule. They concluded that the new measurement of Related Party Transactions (RPTs) in Greece is effective at mitigating the potential misuse of RPTs for Earnings Management (EM) purposes. Furthermore, the earnings quality is said to be declined when a company is associated with RPTs in which have brought consideration to interested groups in Greece (Antonios et al., 2011). With the new regulations on Related Party Transactions (RPTs) coming into effect in Greece, it has increased the efficacy of investors to reduce earnings manipulation by managers (Antonios et al., 2011).

Therefore, based on Agency Theory Type II, it is expected that firms which undertake RPTs will exhibit less accounting quality which is designated by less variability in the change of net income, less variability of change in net income relative to variability of change in cash flows, a more negative correlation between accruals and cash flows and report of small positive net income that is more frequent than firms that do not embark on Related Party Transactions (RPTs). Agency and contracting theories are the two unique theories. Some companies may enter into RPTs due to these two theories. Contracting-theory proposes RPTs can be part of efficient contracting with related parties. RPTs can be a constituent of the overall formal or informal compensation package where RPTs substitute for cash-based compensation to officers and
directors or offer more liquid compensation to officers and directors when executives have high stock option levels.

RPTs also raise concerns based on agency theory that managers will over consume perquisites. This over-consumption damages the firm’s stakeholders (Jensen and Meckling, 1976; Holmstrom, 1992). RPTs that errand the related party to the firm’s detriment represent examples of perquisite consumption. It also can modify the reliability of financial statements thereby plummeting the effectiveness of contracts designed to reduce agency conflicts. The fact that RPTs may put stakeholders at risk has created an urgency to monitor such transactions (Kohlbeck & Mayhew, 2004).

Infamous fraud cases such as Enron, Adelphia and Tyco involved RPTs in some way, producing concern amongst regulators and other participants about the viability of monitoring and auditing of these transactions. Previous researches regarding RPTs generated mixed ideas and conclusions. For example, one particular research has shown that RPTs disclosures are quite mutual (Gordon et al., 2004a). Theory calls for at least two alternative views of RPTs, each with a diverse implication for earnings management. The first view, which is consistent with the portrayal of RPTs in the business press, is that RPTs incorporate agency issues of the type considered by Berle and Means (1932) and Jensen and Meckling (1976). Executives and/or board members have incentives to stage-manage earnings to justify (or increase) these perquisites or perhaps to mask such expropriation.

Another view of RPTs is that it reasonably accomplishes other economic demands of a company or a mechanism that ties the party to the company (Gordon and Henry, 2005). For instance, RPTs can potentially fulfill company demands such as the essential in-depth company knowledge and expertise or the need for alternative forms of compensation. In these cases, there would be no incentives to manage earnings since RPTs won’t need to be obscured or offset; therefore, it is not an expectation in a relationship between earnings management and RPTs. As a bonding mechanism, such transactions would tie the related party to the company, decreasing incentives for the related party to involve in risk-taking behaviour such as earnings management that might endanger the company or the related party’s relationship with the company. In India, RPTs are very special as it is beneficial if the company is an affiliate of a differentiated business group in an emerging market (Khanna and Palepu, 2000). Whether RPTs create or destroy the value of the firms, especially in an emerging market is an open empirical question.

Summary
Related party transactions is not a new issue in the corporate world. Well-known financial scandals involving related party in Malaysia and around the world have brought the attention of all parties to rectify the real problem behind the scandals. The core issue is the effect of related party transactions on earnings quality. Therefore, all accountable parties in the spectrum, from the Government to the managers have to work hand-in-hand to curb this problem from being repeated in the future in order to prevent a freefall in the quality of earnings. Heavy punishment such as penalty or imprisonment for those who engaged in the decreasing of earnings quality through the manipulation of related party transactions has to be implemented. Companies have
to adhere to new laws introduced by the Government and follow all the rules stipulated in the reforms such as Malaysian Code of Corporate Governance and Bursa Malaysia Listing Requirements. In all likelihood, this will reduce the tendency of a company to mishandle transactions among related parties.

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