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Earnings Management: A Case of Related Party Transactions

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ABSTRACT

This study was conducted on the related party transaction (RPT) and earnings management. Agency theory provides that managers may engage into self-enrichment transactions to maximize their benefits at the detriment of the shareholders of the firm. Though, management or concentrated ownership was suggested as the possible solution to this problem, this form of ownership structure has its peculiar problems which are termed as Type II agency problem. Controlling shareholders are found to be using their voting power to extract extra benefits from the firm through the insider information and in many instances engage in detrimental RPTs at the expense of minority shareholders. This study have identified how and why controlling shareholders or managers use RPT as a 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 the controlling shareholders or management against the use of real-activity management through RPT.

Keywords: Related Party Transactions, Accrual-based Earnings Management, Activity-Based Earnings Management
JEL Classifications: G34, G38, G180

1. INTRODUCTION

For many decades, related party transactions (RPTs) have been subject of interest to many stakeholders in the world. These stakeholders comprise a group of academics, investors, regulators, management to just mention but a few. RPTs have been subjected to a number regulation by the parties concern across the globe. This is because; it is regarded as two-sided sword that plays dual roles on the firms operations. It can be for both value-generation and value-destroying purposes. The extents of literature have 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 and Wong, 2010; Loon and Ramos, 2009; Munir et al., 2013). These benefits include reduced transaction cost, speedy decision-making, efficient resource generation and allocation through internal market within the group, and sustenance of important but less profitable business units (Loon and Ramos, 2009). In contrast, some studies argued that RPTs are used by insiders (controlling shareholders and management) as a vehicle for firm and minority shareholders expropriation (Munir et al., 2013; Mustafa et al., 2011). Moreover, Jian and Wong (2010), and Liu and Lu (2003) have argued that the main motive behind RPTs is for earnings management purpose.

Some empirical studies have produced evidence that RPTs are used for tunneling purposes (Du et al., 2013; Jiang et al., 2014), while others have documented that some RPTs are initiated to prop the targeted firms (Gonenc and Hermes, 2008; Ying and Wang, 2013). Other studies revealed that some firms may even engage into fictitious RPTs in order to meet a targeted profit as it was the case in the Enron saga. Whatever is the case, whether the RPTs is used for tunneling, propping or earnings management, they influence the quality of the reported earnings reported in the financial statement, hence hampers the outcomes of the decisions taken based on those reported figures. It is worthy to note that 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 to manage the reported earnings through the use of either accrual or real activities manipulation.

2. RPT

RPT is defined as any transaction that consist of transfer of resources, services or obligations between reporting entity and its related entities regardless of whether consideration is charged or not (IASB, 2005). IAS 24 elaborates the list of parties that can be seen as related to includes but not limited to major shareholders, board members, top management and any other party capable of influencing the decisions of the firm. Nekhili and Cherif (2011) defined RPTs as a transaction between a reporting entity and its related entities as board members, managers, subsidiaries, joint controlled firms, controlling shareholders, associates firms and other similar entities. The transactions of this nature are obtainable in many firms across the world (Jiang et al., 2010; Lin et al., 2010) and more especially in countries with concentrated ownership (Munir et al., 2013) or weak investors' protection (Ma et al., 2013).

Agency theory provides that management (serves as an agent of the shareholders) may not act in the best interest of their shareholders (principal). Managers may possibly involve into opportunistic behavior that will amount to self-service activities at the detriment of the shareholders of the firm (Shleifer and Vishny, 1997). In response to this, the shareholders engage into number of activities to curtail this menace. These activities include the instituting a good corporate governance mechanisms, rising the welfare of management staff or bounding the interest of management with that of the firm. The total costs incurred by the firm in carrying out these strategies is termed as agency cost (Jensen and Meckling, 1976). Moreover, Jensen and Meckling (1976) have argued that high managerial ownership can mitigate the agency problem between shareholders and management. In addition to the above strategies, Shleifer and Vishny (1997) believed that the presence of controlling shareholder monitors the management conduct in a firm.

It must be noted however that high managerial ownership and presence of controlling shareholders has its-own associated costs, as it may expose the minority shareholders to expropriation by the controlling shareholders through insider dealings. This form of agency problem (principal-principal) is referred to as Type II agency problem in many literatures (Du et al., 2013; Fernando et al., 2013; Nekhili and Cherif, 2011). Firms 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 even the presence of strong investors' protection and good legal system cannot completely prevent the minority shareholders from been expropriated by the controlling shareholders in the firm with concentrated ownership. This assertion has been substantiated with some cases of some corporate governance breaches even in the developed nations. Many studies have found that controlling shareholders cannot be acquitted from insider dealings. Kali and Sarkar (2011) have found that the major reason behind firm diversification in many emerging nations is for tunneling purposes. Similarly, Wang and Xiao (2011) documented that controlling shareholders cannot perform their oversight function on management if they are involved in prejudicial transactions.

It is worthy to note that if the firm need to attain some benchmark or during its period of financial difficulties, controlling shareholders may opt to inject their personal resources to meet certain regulatory requirements or to bailout their listed firms from financial turmoil. This act of injecting personal resources into listed firm is called propping (Friedman et al., 2003). Propping is usually done to meet regulatory threshold, induce potential investors, beat some contractual covenants or improve the financial position of a firm (Peng et al., 2011; Ying and Wang, 2013). The theory of market for corporate control provides a theoretical support for propping activities (Jensen and Ruback, 1983). Related party sales are found to be the most commonly used tool for propping (Jian and 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 conforms with the generally accepted accounting principles (Johari et al., 2008) since it will affect the quality of reported earnings and ultimately the financial position of the firm.

3. RPTS AND EARNINGS MANAGEMENT

Earnings management has been described as a situation where managers use available accounting judgements 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. There are numerous incentives that motivate managers to engage into earnings management practices. These incentives include avoidance of small profit, beating analyst forecast, meeting of regulatory requirements, maintenance of existing performance and many more (Chen et al., 2008; Roychowdhury, 2006).

Members of business group and firms with strong government-link were identified with more earnings management activities over their stand-alone counterpart. This can be related with their form of ownership structure which prompts the volume of transactions among the business circle. Many business entities engaged into fictitious related transactions to hide prejudicial actions of the controlling shareholders. Firms can manage their reported earnings through accrual-based earnings management method or non-operating RPTs (Ding et al., 2007). Aharony et al. (2010) have found that many firms use RPTs to exaggerate their performance during pre-initial public offering (IPO) period. They revealed that related party sales are mostly used by IPO firms with their holding firm to enable them inflate their reported earnings in such a way that can 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 (propping) is followed by excessive tunneling by controlling shareholders to wipe out the imported profit from the those IPO firms.

Moreover, Hwang et al. (2013) believed that most of the transactions with offshore related parties are arranged for earnings management purposes. In the same vein, Beuselinck and Deloof (2014) documented that members of business group engage in earnings management more than non-business group firms. The result revealed that the practice is severe in fully owned related party firms compared with the entities with some element of minority interest. These results are in line with the position of Satkunasingam and Shanmugam (2006) on the role of minority shareholders. The authors believed that even though minority shareholders watchdog group are not bold in the discharge of their monitoring responsibility, but the group has a potential on constraining the negative effect of controlling shareholders in the future.

Chen et al. (2008) documented that government-linked firms connive with their respective holding governments (be it local or state) for earnings management practices. This is done usually to maintain the current listing status of the firm or to enable them access a fresh financing through capital market. Recently, He et al. (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 the group members have been influenced by their group decisions and may not portrays the actual under-lying economic position of the individual reporting firm.

4. TYPES OF EARNINGS MANAGEMENT

There are two major forms of earnings management so far in the literature, namely accrual-based and real-activities earnings managements (Cupertino et al., 2015; Gunny, 2010).

4.1. Accrual-based Earnings Management

Accounting estimates and judgements are used in accrual-based earnings management by mangers to manipulate the reported figure. According to Healy and Wahlen (1999) the strategies employed by managers in accrual management include the manipulation in the bad debt estimation, inventory valuation approach, depreciation policy, revenue recognition method and a lot. It is worthy to note that accrual-based earnings management does not affect the cash flow or cash position of the reporting firm, it rather deal mostly with non-cash expenses to change the reported earnings. Jones model as modified by Dechow et al. (1995) is the mostly used to detect the accrual-based earnings management. Under this model, the total accruals (as determine by subtracting operating cash flow from operating profit) are decomposed into its discretionary and non-discretionary components. Discretionary accruals are commonly used to proxy the level of earnings manipulations due to the extent of managerial judgement attached to it.

Liu and Lu (2003) provide empirical evidence that controlling shareholders use discretionary accruals for tunneling purposes. They also revealed that it was conflict of interest between controlling and minority shareholders that fuel the earnings management practices among Chinese firms. Similarly, Ding et al. (2007) have found that RPTs are used to perpetuate or supplement operation-related accrual management. Recently, Hwang et al. (2013) demonstrated that firms manipulate earnings using discretionary accruals through 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 and 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 and Zarowin, 2010; Kuo et al., 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 et al., 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 et al. (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 (2010) finds that among others managers engage in share buyback for entrenchment and earnings purposes. These findings are supported by more recent studies. Burnett et al. (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

This study discussed on how RPTs are used in modern firms for the both value-generation and value-destroying purposes. The study explained how RPTs are used to tunnel or prop related entities. Moreover, it was also revealed that firms engage in some accrual management through RPTs to manipulate the reported earnings. The recent changes in the global accounting environment couple with the detail disclosure requirements by many improved accounting standard have narrowed the frequency in the use of RPTs for accrual management purposes. This change have made the use of real-activities managements to become the order of the day which was used in most cases as a substitute to the accrual earnings management or as compliment in some instances. The paper also revealed that both methods of earnings management can be perpetrated conveniently with the aid of RPTs. 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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