Relationship of Related Party Transactions and Earnings Management

Nur Astri Sari[1*], Rusma Nailiah [2], Achmad Suhaili [3], and Fitria Handayani[4]
[1,2,3,4] Universitas Lambung Mangkurat, Banjarmasin, Indonesia

Abstract

This study aimed to examine the relationship between related party transactions and earnings management. The sample of this study was companies listed on the Indonesia Stock Exchange for the 2017 and 2018 period. The result shows that related party transaction (sales and expense) has a negative effect on accrual earnings management. It indicates that firms use related party transactions (sales and expense) as substitutes for earnings management especially accrual earnings management.
***Keywords**: Earnings Management, Related Party Transaction*.

1. Introduction

A related party diversion is a transfer of resources, services, or liabilities between the reporting entity and related parties, despite whether any prices are charged (PSAK 7). Related party transactions allow agreements to be made that cannot be given to unrelated parties. The existence of a special relationship can influence transactions, balances, and commitments between transacting entities. To avoid related party transactions that can harm minority shareholders, Financial Services Authority (OJK) has issued OJK Regulation Number X.E.1 concerning Affiliated Transactions and Conflict of Interest on Certain Transactions. In this regulation, particularly for transactions containing a conflict of interest, independent shareholders must first approve them at the General Meeting of Shareholders (GMS).

Related party transactions are commonly conducted by directors or majority shareholders with their affiliates by using the authority to influence the conditions of the transactions to suit their personal objectives. Chen, Cheng, and Xiao (2011) revealed that related party transactions are an alternative that can be utilized by companies to manage earnings.

Earnings management is a management activity of earnings performed by a company to achieve a specific purpose. Often earnings management practices benefit the majority shareholder only and harm minority shareholders (tunneling activities). In this condition, management manipulates reported earnings opportunistically which reduces the information on actual earnings generated by the company.

Ryngaert and Thomas (2012) showed that related party transactions indicate the potential for expropriation by internal parties to shareholders through self-dealing. Besides, research results by Kohlbeck and Mayhew (2017) found that related party transactions provide a signal that the internal company is conducting self-dealing transactions between the company and management or the majority shareholders. The activities performed by management indicate that related party transactions are used as a tool for earnings management. Research conducted by Chen et al. (2011) indicated that related party transactions are used as a separate method for managing reported earnings, that not all of them use accrual earnings management but can also be cash-based (real earnings management). El-Helaly, Georgiou, and Lowe (2018) found that real earnings management and related party transactions have a substitution relationship.

Based on this background, this research would discuss the relationship between related party transactions and earnings management occurring in Indonesia. Earnings management mechanisms that would be used in this study were real earnings management and accrual earnings management. To determine the relationship between related party transactions and earnings management, the problem formulations used in

* Corresponding author. *Email address* : nurastrisari@ulm.ac.id

this study were: 1) Are related party transactions related to real management? and 2) Are related party transactions related to accrual earnings management?.

2. Theoretical Basis and Hypothesis Development

2.1. Agency Theory

Agency theory discusses the relationship between two parties, in which one party (agent) agrees to perform something as a representation of the other party (principal) (Schroeder, Clark, & Cathey, 2009). The assumption used in the agency theory is that each individual will act to maximize their personal interest. Therefore, the agency relationship will create the possibility of agency conflict.

A concentrated ownership structure can lead to agency conflicts. Controlling shareholders have the potential to be heavily involved in company management and obtain more accurate information concerning the operations of the business than minority shareholders. This concentrated ownership structure tends to result in a shift in agency conflict, starting from a conflict of interest between management and shareholders to that between controlling shareholders together with management and minority shareholders (Villalonga & Amit, 2006).

2.2. Earnings Management

Ayres (1994) defined earnings management as "an intentional structuring of reporting or production/investment decisions around bottom line impact". Another definition of earnings management is "the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective" (Scott, 2009).

Earnings management is performed by companies to achieve particular objectives. There are several motives behind the earnings management practices (Scott, 2009), including for the purpose of obtaining bonuses, avoiding contract violations, maximizing stock prices during the initial offering, or to meet investors' expectations. Besides, earnings management can also be performed to fulfill the objectives of the majority shareholder, which is often a detrimental practice for minority shareholders. In this situation, management manipulates reported earnings opportunistically, reducing the information on actual earnings generated by the company.

Earnings management practices can be performed through several methods. According to Ayres (1994), three earnings management methods can be used by managers, including: accruals management, adoption of mandatory accounting changes, and voluntary accounting changes. Besides, companies can also use other methods of real earnings management. Roychowdhury (2006) measured real earnings management using a proxy for abnormal cash flows from operating activities. This abnormality resulted from an acceleration of sales time through an increase in sales discounts and easier credit terms.

2.3. Transactions with Related Parties

Based on PSAK 7 (2015 Improvement) concerning Related Party Disclosures, a related party is defined as a person or entity that is related to the reporting entity that prepares its financial statements. The person or the closest family member has a relative if:

1. They have control or joint control on the reporting entity;
2. They have a significant influence on the reporting entity; or
3. Personal key management of the reporting entity or a parent of the reporting entity.

An entity is related to a reporting entity if it is included in one of the categories below:

a. The entity and the reporting entity are members of the same business group;
b. An entity is an associate or joint venture of another entity;
c. The two entities are joint ventures of the same third party;

d. One entity is a joint venture of a third entity and the other entity is an associate of the third entity;
e. The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity;
f. An entity that is controlled or jointly controlled by a person is identified in this category; and
g. An entity or a member of a group of which the entity is part of the group provides key management personnel services to the reporting entity or a parent of the reporting entity.

A related party diversion is a transfer of resources, services, or liabilities between the reporting entity and related parties, despite whether any prices are charged (PSAK 7). Related party transactions allow agreements to be made that cannot be given to unrelated parties. The existence of a special relationship can influence transactions, balances, and commitments between transacting entities. As previously stated, related parties include people or entities that are associated with the reporting entity. This special relationship is examined based on the substance of the relationship, not only in the form of the legal relationship that occurs.

2.4. Hypotheses Development

The results of previous studies show that related party transactions indicate the potential for expropriation performed by internal companies to the shareholders through self-dealing (Ryngaert & Thomas, 2012) and provide benefits to related parties by using resources that are also owned by minority shareholders (Djankov, La Porta, Lopez-De-Silanes, & Shleifer, 2008). Besides, research results by Kohlbeck and Mayhew (2017) found that related party transactions provide a signal that the internal company is conducting self-dealing transactions between the company and management or the majority shareholder. The activities performed by management indicate the occurrence of earnings management practices.

A study by Chen et al. (2011) indicated that related party transactions are used as a separate method for managing reported earnings, that not all of them use accrual earnings management but can also be cash-based (real earnings management). If related party transactions are used as a separate method for managing earnings, then the company can use related party transactions, accrual earnings management, and real earnings management in carrying out earnings management.

El-Helaly et al. (2018) who researched the Greek stock exchange for the 2009-2014 period found that real earnings management and related party transactions have a substitution relationship. On the other hand, this study did not find a significant relationship between accrual earnings management and related party transactions.

The positive relationship between related party transactions and earnings management proves that related party transactions are used simultaneously with other earnings management methods for opportunistic purposes (Kohlbeck & Mayhew, 2017). However, the negative relationship between related party transactions and earnings management indicates that the company utilizes related party transactions as an alternative method of managing earnings as a substitute for accruals and real earnings management (El-Helaly et al., 2018). Related party transactions and earnings management that are not empirically proven to have a relationship indicate that the related party transactions that occur are purely ordinary business transactions.

Based on the theoretical review and the results of previous studies, the hypotheses to be used in this study are as follows:

H1: Related party transactions are related to real earnings management.

H2: Related party transactions are related to accrual earnings management.

3. Research Methods

There were two models used in this study. Model 1 was used to test the H1 hypothesis. Model 2 was used to test the H2 hypothesis.

Model 1: $REM_i = \alpha 1 + \alpha 2\ RPT_i + \alpha 3\ QADT_i + \alpha 4\ LEV_i + \alpha 5\ SIZE_i + e_i$ (1)
Model 2: $AEM_i = \beta 1 + \beta 2\ RPT_i + \beta 3\ QADT_i + \beta 4\ LEV_i + \beta 5\ SIZE_i + e_i$ (2)

Besides the main research variable of related party transactions, several control variables were also included which also influence management decisions in implementing earnings management practices. The control variables used in this study were audit quality (Siregar & Bachtiar, 2005), leverage (Jara & Lopez, 2008), and firm size (Michaelson, James, & Charles, 1995).

Table 1 Variable Operationalization

Variable	Description	Measurement
REM	*Real Earnings Management*	Using Roychowdhury models (2006) $CFOit/ASETit\text{-}1=\alpha 1+\alpha 21/ASETit\text{-}1+\alpha 3REVit/ASETit\text{-}1 + \Delta REVit/ASETit\text{-}1+eit$ CFO : cash flow from operating activities; ASSET : total assets; and REV : Income. Praktek *real earnings management* characterized by the presence of abnormal operating cash flow. Abnormal CFOs are estimated through residuals from the models above.
AEM	*Accrual Earnings Management*	Using the Kasznik model (1999) $TA_{it} = \alpha_0 + \alpha_1 (\Delta REV_{it} - \Delta REC_{it}) + \alpha_2 PPE_{it} + \alpha_3 \Delta CFO_{it} + e_{it}$ TA : total accrual of the company the difference between net income and cash flow from operating activities; REV : Income; REC : net receivables; PPE :*gross property, plant* and *equipment* company *i* in *t* year; and CFO : cash flow from operating activities Based on the model, accrual earnings management is formulated into: $AEM = TA_{it} - [\alpha_0 + \alpha_1 (\Delta REV_{it} - \Delta REC_{it}) + \alpha_2 PPE_{it} + \alpha_3 \Delta CFO_{it}]$ All variables scaled with total $assets_{it-1}$.
RPT	Related Party Transactions	This study divided into two categories of related party transactions based on the presentation of financial statements, namely those derived from financial position statements and profit and loss statements. The first measurement uses the amount of assets and liabilities related to the company's total equity (RPTAL): RPTAL=(RPTA+RPTL)/ Equity Description: RPTAL : related party transactions of assets and liabilities;

		RPTA : number of assets related to related parties; RPTL : the amount of liabilities associated with related parties; and Equity : total Equity. The second measure uses the amount of income and expenses associated with the company's total equity (RPTSE): RPTSE=(RPTS+RPTE)/ Equity description: RPTSE : related party transactions income and expenses; RPTS : the amount of income associated with related parties; RPTE : the amount of expenses associated with related parties; and Equity : total Equity.
QADT	Audit quality	*Dummy variable*, 1 if audited by the Big Four and 0 if audited other than the Big Four
LEV	*Leverage*	Ratio of total debt to total assets
SIZE	Company size	Natural logarithm of total assets

The population of this study was all companies listed on the Indonesia Stock Exchange (IDX). The research period was 2017 and 2018. The sample selection used purposive sampling with the criteria of having financial reports, having data related to related party transactions, and was not included in the financial industry. The sample used in this study were 218 companies.

4. Research Results

The results of the processing of the research model were shown in Table 2. Based on Table 2, the F probability for models 1 and 2 was statistically significant. It shows that the independent variables have a significant effect on the dependent variable simultaneously. Besides, the R^2 of research model 1 was 8.17%. It shows that the independent variable was able to explain 8.17% of the variation of the dependent variable. Meanwhile, R^2 for research model 2 was 6.11%. It shows that the independent variable was only able to explain 6.11% of the variation of the dependent variable. Based on the research results, when viewed from the R^2 level, model 1 was better than model 2.

Table 2 Model 1 and 2 Regression Results

Variable	Coefficient	Robust Std. Error	t-stat	Prob.
Model 1: REM				
Intercept	0.2732	0.1031	2.65	0.008***
RPTA	-0.0647	0.0427	-1.51	0.131
RPTSE	0.0467	0.0334	1.40	0.163
QADT	0.0614	0.0168	3.65	0.000***
LEV	0.1241	0.0815	1.52	0.129
SIZE	-0.0232	0.0078	-2.97	0.003***
R^2	0.0817			
F-stat	6.12			
Prob F	0.0000***			
Model 2: AEM				
Intercept	0.0068	0.0729	0.09	0.926

RPTA	0.0189	0.0140	1.35	0.177
	-0.0191	0.0102	-	0.063*
RPTSE			1.86	
	-0.0064	0.0139	-	0.645
QADT			0.46	
	-0.1300	0.0414	-	0.002***
LEV			3.14	
SIZE	0.0036	0.0046	0.78	0.434
R^2	0.0611			
F-stat	6.46			
Prob F	0.0000***			

Based on Table 2, the analysis for hypotheses H1 and H2 was as follows:

1. *Real earnings management*

a. RPTA

The RPTA regression coefficient was -0.0647 with a significance level of 0.131. The results of this study indicate that the activities of related party transactions related to assets and liabilities performed by the company do not have significantly affect the real earnings management practices statistically.

b. RPTSE

The RPTSE regression coefficient was 0.0467 with a significance level of 0.163. The research results indicate that the company's related party transaction activities related to income and expenses do not significantly affect real earnings management practices statistically.

Based on the results of the two tests above, it can be concluded that the H1 hypothesis cannot be accepted. It indicates that the related party transactions are not related to or affect real earnings management practices.

2. *Accrual earnings management*

a. RPTA

The RPTA regression coefficient was 0.0189 with a significance level of 0.177. The research results indicate that the related party transaction activities related to assets and liabilities performed by the company do not significantly affect the accrual earnings management practices statistically.

b. RPTSE

The RPTSE regression coefficient was -0.0191 with a significance level of 0.063. With a confidence level of 90%. The research results indicate that the company's related party transaction activities related to income and expenses have a significant negative effect on real earnings management.

Based on the results of the two tests above, it can be concluded that the H2 hypothesis is accepted. The results of this study are in line with El-Helaly et al. (2018). The negative relationship between related party transactions (income and expenses) and earnings management indicates that the company utilizes related party transactions as an alternative method of managing earnings as a substitute for accrual earnings management.

5. Conclusions, Implications, and Limitations

5.1. Conclusions

A related party diversion is a transfer of resources, services, or liabilities between the reporting entity and related parties, despite whether any prices are charged (PSAK 7). Related party transactions allow agreements to be made that cannot be given to unrelated parties. The existence of a special relationship can influence transactions, balances, and commitments between transacting entities. These related party transaction practices can be abusive or efficient.

Based on the results of this study, the following conclusions can be drawn:

1. Based on the results of testing model 1, it can be concluded that the H1 hypothesis cannot be accepted. It shows that related party transactions are not related to or affect real earnings management practices.
2. Based on the results of testing model 2, it can be concluded that the H2 hypothesis is accepted. The research results are in line with El-Helaly et al. (2018). The negative relationship between related party transactions (income and expenses) and earnings management indicates that the company utilizes related party transactions as an alternative method of earnings management as a substitute for accrual earnings management.

5.2. Implications

Based on the results of this study, several implications can be given, including:

1. Regulator
   The research results indicate that the related party transactions performed by the company are utilized as alternative earnings management. It is an indication of the need to improve regulations or standards related to related party transactions.
2. Investor
   The research results give an overview that the company's related party transactions are used for earnings management. Therefore, they can provide a signal to investors that companies that perform a lot of related party transactions tend to do so for earnings management.
3. Companies
   The research results indicate that companies that perform related party transactions tend to be utilized for earnings management. It needs to become a consideration for management in the decision-making process, particularly related to related party transactions so as not to harm the interests of minority shareholders.

5.3. Limitations

There are several limitations in this study, including:

1. The research period was only in 2017 and 2018.
2. Related party transactions are only measured using the amount of the transactions.

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