

# CHAPTER 1

## INTRODUCTION

### 1.1 Motivation and Research Questions

The economic crash in 1997 caused severe financial problems in Thailand. Manipulation, insufficient disclosure and lack of transparency in firm's operations and controls are blamed. To reestablish confidence and trust in financial information and disclosure, the **Institute of Certified Accountants and Auditors of Thailand (ICAAT)**, currently known as the **Federation of Accounting Professions (FAP)**, conducted an enormous improvement in *Thai Accounting Standards (TAS)*. The **Stock Exchange of Thailand (SET)** and the **Securities and Exchange Commission (SEC)** also initiated various guidelines and monitoring mechanisms.

After the financial distress, there has been a great improvement in TAS. During 1999-2000, ICAAT issued the accounting conceptual framework and many new accounting standards. All the new TAS are based on *International Accounting Standards (IAS)* with only a few exceptions. TAS 47, *Related Party Disclosures*, is one of the improvements.

TAS 47 is based on IAS 24, *Related Party Disclosures*, without major differences. Owing to the financial crisis, the accounting standard on related party disclosure was revised after the previous one had existed for eleven years. TAS 47 supersedes TAS 13, which was issued in 1989. TAS 47 specifies the characteristics of related party relationships. It also identifies the disclosure requirements for a reporting

entity when there is a related party relationship or related party transactions. This standard became effective for financial statements beginning on or after January 1, 2000. Non-listed companies are exempted from TAS 47.

In addition to ICAAT, SET takes part in boosting confidence and trust in the Thai capital market. In an attempt to develop and ensure good governance of listed companies, SET enforces good corporate governance as well as listed company disclosure rules and guidelines.

In 2002, SET issued fifteen principles for good corporate governance. Starting on December 31, 2002, listed companies must show in their annual reports and annual registration statements (Form 56-1) how these principles have been implemented. One of the fifteen good corporate governance principles relates to conflicts of interest. SET will assess the complete disclosed information for how the board of directors handles inside information, conflicts of interest and connected transactions. The assessment will be reported annually in a *Good Governance Assessment of Listed Companies* (The Stock Exchange of Thailand, 2003a).

In 2003, SET announced the regulation of connected transactions. Connected transactions are almost the same as related party transactions, except that they do not include transactions with associated entities. In addition, connected transactions cover transactions with persons whose behavior can indicate they are acting on behalf of or are under the major influence of persons or juristic persons who have a major influence over the listed companies.

*The Notification of the Board of Governors of the Stock Exchange of Thailand: Re: Disclosure of Information and Other Acts of Listed Companies Concerning the Connected Transactions, 2003* (Bor. Jor./ Phor. 22-01) describes the disclosure for connected transactions and the procedure for listed companies to deal with them. This announcement was issued in 2001 to supersede the prior announcement. However, this paper focuses on related party transactions following TAS 47, with emphasis disclosures in the notes to financial statements of listed companies.

Along with ICAAT and SET, SEC also plays an important role in the supervision of listed companies. *SEC News*, disseminated through its website ([www.sec.or.th](http://www.sec.or.th)), regularly reports information related to listed companies. This includes the alteration and announcement of rules and regulations; the punishment of management, auditors and market officers; and the SEC requirement for financial reporting restatements of listed companies. Since financial statements are material information needed for decision-making, *SEC News* assists shareholders to accurately evaluate the risks involved in the listed companies' securities.

Claims related to financial reporting in *SEC News* during 1999 to 2006 included Generally Accepted Accounting Principles (GAAP) violations, management expropriations, insider trading, and share price manipulation. Included in these *SEC News* are 33 cases (26 firms) related to GAAP violations, and 15 cases (15 firms) of deficiency in disclosure and presentation of related party transactions.<sup>1</sup>

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<sup>1</sup> Where 7 cases are allowance setting, 7 cases are revenue recognition, 8 cases are assets valuation, and 1 case is expense recognition (5 cases are accused for 2 issues). Details are available in Appendix A.

The effort and enforcement by standard setters and regulators to control for the presentation and disclosure of related party transactions as explained earlier implies the importance of related party transactions so that it now plays a more important role in Thai financial reporting.

The corporate characteristics of East Asian countries, including Thailand, also strengthen the importance of related party transactions. East Asian firms are extensively family-controlled through the pyramid structure, the cross-holdings structure and the tight connection between the controlling families and management (Claessens, Djankov and Lang, 2000). Controlling shareholders have almost full control over managers and frequently possess controlling power in excess of their cash flow rights. The smaller portion of cash flow rights relative to controlling power fails to align the interests of controlling shareholders with those of outside shareholders. Controlling shareholders thus possess both incentives and the ability to report the financial information for their own interests.

In particular, Thai listed firms are mainly family-controlled. The corporate structure of Thailand is characterized by informal alliances among a small number of families. These families collectively possess a large share of a corporation, with one family in the alliance taking the role of principal controlling shareholder. The ten largest business families in Thailand control almost half of Thai listed corporations (Claessens et al., 2000). Firms controlled by corporate groups are also found to have more related party transactions than firms that are state-enterprises and private businesses (Jian and Wong, 2003).

The previously mentioned efforts and enforcements by standard setters and regulators as well as the characteristic of family business groups suggest the importance role of presentation and disclosure of related party transactions. These transactions should be perceived as the red flag in financial statement analysis and considered in risk assessment before making economic decisions.

Although related party transactions are the common cause of corporate scandal and the red flag for financial statement analysis, studies of related party transactions are rare. This is especially true in Thailand. Related party transactions are the most frequent claim of SEC to request financial reporting restatements. However, in reviewing the literature, the studies of related party transactions in Thailand were not found. This increases the importance of this study on related party transactions.

From the effort of standard setters and regulators to control the presentation and disclosure of related party transactions; the evidence that related party transactions are a common cause of financial reporting restatements; and the corporate structure of extensive family-controlled business groups, this paper conjectures that managers may exercise discretionary control over reported earnings through related party transactions. This leads to two questions in this study. Firstly: *Do managers of Thai listed companies exercise discretion over related party transactions?* Secondly: *How are related party transactions applied in earnings management?*

## **1.2 Research Objectives**

This paper focuses on related party transactions and earnings management practices in Thailand. The objective of this study is to investigate the application of related party transactions in earnings management. This study aims to increase the limited empirical studies on related party transactions because the latter are a common cause of corporate scandal and financial reporting restatements.

## **1.3 Scope of Study**

As mentioned earlier, this study investigates the discretionary control of management over related party transactions. This study considers the characteristic of extensive family-controlled business groups in Thai listed firms and proposes a modified model to estimate discretionary accruals. The model extracts the portion of transactions with related parties from the nondiscretionary accruals component due to the concern that managers may exercise discretionary control over related party transactions.

This study explores the relationship between related party transactions and discretionary accruals of listed companies in the **Stock Exchange of Thailand** during 2003 to 2005.

In order to investigate whether managers exercise discretionary control over related party transactions, the association of discretionary accruals with net value of all related party transactions collected from the notes to financial statements is first explored. Furthermore, to provide further evidence on how managers apply related party

transactions to earnings management, the studies on which activity, which direction and which type of related party transactions that are associated with discretionary accruals are also examined.

Related party transactions information was collected from the notes to financial statements of listed companies. This information is disclosed under the note titled “*Related Party Transactions*” or “*Transactions with Related Parties*”. Therefore, the definition of related party transactions in this study is that found in TAS 47 where the information is disclosed in the notes to financial statements.

According to TAS 47, related party transactions include transactions within the following relationships:<sup>2</sup>

- (1) entities that control or are controlled by, or are under the common control of the reporting entity,
- (2) associated entities of the reporting entity,
- (3) individuals and close family members who by having an interest in the voting power, have significant influence over the reporting entity,
- (4) key management personnel, and their close family members, and
- (5) entities in which a substantial interest in the voting power is owned directly or indirectly by any person described in (3) or (4), or over which such an individual is able to exercise significant influence.

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<sup>2</sup> Angkarat Priebjrivat, Abridged Thai Accounting Standards (December 2003). (Bangkok: The Stock Exchange of Thailand, 2004), p. 131.

## **1.4 Contributions**

This study provides contributions to accounting literature, investors, shareholders, auditors, standard setters and regulators as described below.

Firstly, this study contributes to the accounting literature by increasing the evidence on related party transactions. This study is one of few studies that explores the application of related party transactions in earnings management. Although related party transactions are the usual cause of corporate scandals and the warning sign for financial statement analysis, the studies of related party transactions are rarely found. In particular, the SEC's requests for financial reporting restatements of Thai listed companies are often caused by the related party transactions issue. Nonetheless, in the review of the literature, studies of related party transactions in Thailand were not found. This paper is the first study that provides empirical evidence on earnings management through related party transactions in Thailand.

Secondly, this study contributes to the literature on earnings management by extending the methodology to assess discretionary accruals. This study considers the characteristic of family-controlled business groups in East Asia in general and in Thailand in particular. A previous study reports that the ten largest business families in Thailand control almost half of Thai listed companies (Claessens et al., 2000). Firms under the control of corporate groups also have more related party transactions than firms that are state-enterprises or private businesses (Jian and Wong, 2003). Furthermore, as discussed earlier, related party transactions are the most frequent claim by SEC to request financial reporting restatements. Consequently, a modified model to estimate



discretionary accruals is proposed. This model extracts the portion of transactions with related parties from the nondiscretionary accruals component.

Thirdly, the results from this study encourage investors and shareholders to increase awareness about related party transactions and to increase their considerations of the likelihood of earnings management as well as their need for risk assessment. Both local and foreign investors have to be wary when using earnings figures and making investment decisions. Besides the earnings figures, investors have to analyze other fundamental components of the company to determine firm performance in order to assess stock value and reduce investment risk.

Moreover, the evidence from this study encourages auditors to review and audit financial statements to make sure that they comply with accounting standards, rules and regulations in general and in particular that related to transactions with related parties. Furthermore, this study suggests that public accounting firms provide its employees the training and continuing education on earnings management and other related topics.

Finally, the results from this study advocate standard setters and regulators to consider the rules, regulations, and other mechanisms in order to control and reduce management incentives and opportunities to manage earnings. Even though there is no requirement for positive earnings as in the IPO process, the company still has an incentive to manage income to show preferable earnings for a given purpose. Therefore, rules, regulations, and other mechanisms, such as good corporate governance, have to be rigorously supervised to ensure effective compliance. This is to provide the confidence

and trust in financial statements. Training and education courses are also helpful. These courses should focus on educating investors about earnings management and accentuate the deficiencies in disclosure and presentation from real cases as well as the approaches to detect earnings management.

## **1.5 Dissertation Organization**

The dissertation proceeds as follows. Chapter 2 is the literature review. Chapter 3 contains the research hypothesis and design. Chapter 4 discusses the empirical results and Chapter 5 provides the conclusions of this study.