

CHAPTER 5

CONCLUSIONS

5.1 Summary of the Study

After the financial crisis in 1997, Thailand introduced improvements in the financial reporting rules and regulations in order to restore confidence and trust in financial information and disclosure. Transactions with related parties are an issue that receives great attention from standard setters, regulators, and the public.

The **Institute of Certified Accountants and Auditors of Thailand** (ICAAT), currently known as the **Federation of Accounting Professions** (FAP), conducted improvements in *Thai Accounting Standards* (TAS) on related party transactions. TAS 47, *Related Party Disclosures*, was revised and became effective in 2000, eleven years after the issue of the prior accounting standard on related party disclosures.

The **Stock Exchange of Thailand** (SET) initiated regulation concerning the disclosure of information on connected transactions in 2001. This was replaced by a revised regulation in 2003. Connected transactions are similar to related party transactions, except that they do not cover transactions with associated entities. However, connected transactions includes transactions with persons whose behavior can indicate they are acting on behalf of or are under the major influence of persons or juristic persons with a major influence in the listed companies.

SET also includes connected transactions considerations in the fifteen principles for good corporate governance issued in 2002. SET reviews the complete

disclosure on connected transactions and reports the assessment annually in a *Good Governance Assessment of Listed Companies* (The Stock Exchange of Thailand, 2003a).

Since 1999, the **Securities and Exchange Commission** (SEC) has published the *SEC News* to disseminate information related to Thai listed companies. From 1999 to 2006, *SEC News* reported violations of the Generally Accepted Accounting Principles (GAAP) for 33 cases (26 firms) of these 15 cases (15 firms) are deficiencies in the disclosure and presentation of transactions with related parties.¹

The corporate structure in East Asian countries, including Thailand, also increases the important role of related party transactions in financial reporting. An existing study reports that East Asian listed corporations, including Thai listed companies, have an extensively family-controlled structure. Thai listed firms also have a structure of informal alliances among a small number of families, who collectively possess a large share of a corporation (Claessens et al., 2000). In addition, researchers find that firms controlled by corporate groups have more related party transactions than firms that are state-enterprises and private businesses (Jian and Wong, 2003).

From the standard setters' and regulators' attempts and enforcements to control the presentation and disclosure of transactions with related parties; the evidence that related party transactions are the common cause of financial reporting restatements; and the structure of extensive family-controlled business groups in Thai listed companies, this paper hypothesizes that managers may exercise discretion over related party transactions to manipulate the reported income.

¹ Details are available in Appendix A.

This paper focuses on the application of related party transactions in earnings management. Owing to the concern that managers may exercise discretionary control over related party transactions, this study proposes a modified model to estimate discretionary accruals. This model extracts the portion of transactions with related parties from the nondiscretionary accruals component.

The analyses use multiple regression to investigate the association between related party transactions and discretionary accruals in Thai listed firms that had related party transactions during 2003 to 2005. The definition of related party transactions in this study is that found in TAS 47 where the information is disclosed in notes to financial statements of the listed companies.

The association of discretionary accruals with the net value of all related party transactions collected from the notes to financial statements is first explored in order to examine whether managers apply discretion over related party transactions. The studies on which activity, which direction and which type of related party transactions that are associated with discretionary accruals are also examined to provide evidence on how managers apply related party transactions in earnings management. This study also examines models separately for firms with positive and negative discretionary accruals to study the opportunistic behavior of each sample group.

Descriptive statistics illustrate that while the growth opportunity is better in the positive discretionary accruals sample, the negative discretionary accruals sample has a bigger firm size. The leverage and the firm performance of the negative discretionary accruals sample are also higher.

In addition, on average, the negative discretionary accruals sample has more related party transactions than the positive discretionary accruals sample. In addition, the largest transactions with related parties are from operating activities. In the full sample and the negative discretionary accruals sample, the three largest items of related party transactions are sales and services revenue, purchase of materials and services, and short-term borrowing. The three greatest related party transactions in the positive discretionary accruals sample are sales and services revenue, purchase of materials and services, and other expenses.

Multiple regression analyses show that discretionary accruals are positively related to the transactions with related parties. This is consistent with the hypothesis. The result suggests that larger related party transactions are associated with greater earnings management.

5.2 Interpretation of the Results

This study provides evidence that related party transactions are one of accounting procedures that managers use to manage earnings. Since they are transactions with parties that have close connections with the firm, managers can negotiate the policy, pricing and timing of these transactions.

The occurrence of related party transactions involves various business activities. The findings from the full sample suggest that related party transactions from operating and investing activities are related to earnings management. An analysis of types of related party transactions shows that the larger of sales and services revenue

from related parties are associated with greater earnings management. While the higher of purchase of materials and services as well as acquisition of assets from related parties are related to lower earnings management. The opposites are also true.

Existing studies also report that companies manipulate the operating transactions and investing transactions when they have an incentive to show favorable earnings figures. Examples of these operating transactions found in the literature are depreciation expenses (Teoh, Wong and Rao, 1998), sales and operating expenses (Plummer and Mest, 2001) and sales to related parties (Jian and Wong, 2003). Research and development expenditure is an example of investment transactions reported in an earlier study (Dechow and Sloan, 1991).

Furthermore, the higher the financing transactions with related parties indicate the lower earnings management. Prior studies find that firms manage earnings to avoid the constraints in debt covenants and the costs from debt covenant violations (Watts and Zimmerman, 1986; 1990; DeFond and Jiambalvo, 1994). Normally, the constraints of debt covenants with related parties are less strict than the constraints with outsiders. Therefore, firms with higher borrowing from related parties, which implies lower borrowing from outsiders, have less incentive to manage earnings. Therefore, the results show a negative association between financing transactions with related parties and earnings management.

In addition, the sample is separated into two groups. These are positive discretionary accruals sample group and negative discretionary accruals sample group.

The former represents an attempt to manage earnings upwards and the latter represents an attempt to manage earnings downwards.

In firms where there is an attempt to manage earnings upward, earnings management is associated with related party transactions from operating and financing activities. Larger operating transactions with related parties are associated with greater earnings management. However, the higher the financing transactions with related parties, the lower the earnings management. This is because it implies there is less incentive to manage earnings as in an earlier discussion. Examination of the types of related party transactions that are applied in earnings management, suggests that companies increase the sales and services revenue from related parties to achieve their objective of increasing income. While the greater the long-term borrowing from related parties indicates the lower earnings management.

In firms with an attempt to manage earnings downward, discretionary control is applied over related party transactions in investing and financing activities. The higher the investing transactions with related parties, the greater the earnings management. Whereas the greater the financing transactions with related parties implies a lower incentive for earnings manipulation, as discussed earlier. The analysis observing the types of related party transactions shows that the higher the assets acquisition from related parties, the lower the earnings management. This is because firms with more acquisition of assets will have more depreciation expenses, which already reduces earnings figure. Therefore, they have less incentive to manage earnings downward.

5.3 Implications and Contributions of the Study

5.3.1 Accounting Research

This paper extends the accounting literature by studying the specific conditions of Thai listed corporations, which differ from other countries. The corporate structure of extensive family-controlled business groups and the real accounting cases of Thai listed companies encourage the important role of related party transactions in Thai financial reporting. Therefore, this study proposes an adjustment to the existing methodology to measure discretionary accruals and develops an empirical study to support the effect of related party transactions on reported earnings.

The evidence that managers apply discretionary control over related party transactions strengthens an awareness of the impact of specific accounting transactions on the reported financial performance. The consideration of related party transactions as a red flag to financial statement analysis is discussed in articles and text books, but empirical evidence is rarely found.

5.3.2 Investors and Shareholders

The finding that managers apply discretionary control over related party transactions encourages investors and shareholders to pay more attention to related party transactions disclosure. The irregular occurrence of related party transactions should make investors and shareholders wary. For example, some related party transactions may not be on an arm's length basis, some may occur on different conditions with unrelated

parties, and some transactions may occur only with related parties but not with unrelated parties at all.

Investors and shareholders should pay more attention to the likelihood of earnings management and increase the consideration on risk assessment when using the earnings figures and making investment decisions. In addition to the earnings figures, investors have to consider other fundamental components of the company to evaluate its performance in order to assess stock value and reduce investment risk.

5.3.3 Auditors

The evidence of earnings management through related party transactions encourages auditors to review and audit financial statements to verify that they conform to accounting standards, rules and regulations. Especially those related to transactions with related parties.

Education about earnings management is also important. Public accounting firms should provide continuous training and education courses to their employees on earnings management and other relevant topics.

5.3.4 Standard Setters and Regulators

Results of this study encourage standard setters and regulators to consider the rules, regulations, and other mechanisms to control and reduce management incentives and opportunities to manage earnings. To guarantee confidence and trust in financial reporting, the rules, regulations, and other mechanisms, such as good corporate

governance, have to be thoroughly supervised to ensure effective implementation and enforcement.

Another suggestion is to provide investors with earnings management knowledge. For example, training and education courses emphasizing how to detect earnings management as well as disclosure deficiencies and misrepresentation from real cases.

5.4 Limitations

The limitation of this study is the same as in other earnings management studies. The critical issue of earnings management studies is the capacity of the model to estimate the discretionary accruals. The results are based on the assumption that the discretionary accruals estimation model can accurately assess the discretionary component of accruals.

The use of net value of related party transactions may affect the relationship between discretionary accruals and related party transactions. This may cause an insignificant result of the relationship because the impact of related party transactions to discretionary accruals may be offset when using the net value instead of the absolute value. For example, firms making an effort to manage earnings upward may increase revenue transactions from related parties, or decrease expense transactions from related parties, or both. When these values are offset, in model (1) and (2), the impact to discretionary accruals may be reduced.

5.5 Future Research

Future research should examine related party transactions under other classification criteria. For example, future research may classify the related party transactions by the level of relationship or by the pricing policy. Such results will extend the analysis and provide alternative explanations for related party transactions studies.

Furthermore, future research can investigate factors that affect related party transactions. For example, future research may examine the incentives and mechanisms to diminish and control the discretion in transactions with related parties. The results can assist standard setters and regulators to reduce inappropriate discretionary control in financial reporting.