

**RELATED PARTY (RP) TRANSACTIONS, EARNINGS QUALITY AND FIRM
VALUATIONS: CROSS-COUNTRY EVIDENCE FROM EAST ASIA**

Submitted by

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Statement of Authorship

“Except where reference is made in the text of the thesis, this thesis contains no material published elsewhere or extracted in whole or in part from a thesis by which I have qualified for or been awarded another degree or diploma.

No other person’s work has been used without due acknowledgements in the main text of the thesis.

This thesis has not been submitted for the award of any”.

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11 June 2013

Abstract

This study investigates the effect of related party (RP) transactions on earnings quality and firm valuation of firms in East Asia. This study uses a sample of 423 listed firm comprising 1,269 firm-year observations from Hong Kong, Malaysia, Singapore and Thailand over the period 2008-2010. This study measures RP transactions using the magnitude and abnormal RP transactions. This study uses discretionary accruals as a proxy of earnings quality, which is measured from modified Jones (Dechow et al., 1995) and performance-matched discretionary accrual (Kothari et al., 2005) model. This study also uses three different models, Tobin's Q, earnings-market valuation (MVE), and earnings informativeness (RET) to examine the effect of RP transactions on firm valuation.

This study finds empirical evidence that RP transactions are significantly associated with discretionary accruals. This study also finds that RP Simple has a positive and significant relation to discretionary accruals but RP Complex is insignificant. These findings suggest that firms engage in RP transactions, particularly RP Simple have significantly lower earnings quality. This study also finds that firms engaged in more RP transactions have significantly lower market valuation, lower performance and lower informativeness of earnings. This finding is robust after controlling for firm specific attributes, corporate governance, ownership structure, earnings quality and many sensitivity tests.

Consistent with Kohlbeck and Mayhew (2010), this evidence suggests that investors perceive RP Complex, RP Simple, and RP Loan affect firm valuation differently. These results support the conflict of interest view that RP transactions reflect potential for wealth expropriation and lead to the market discounting firms that are more engaged in transactions with related parties.

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Chapter 1

INTRODUCTION

1.1 Preview

Related party (RP) transactions are a normal feature of business, because many entities frequently carry on their activities through subsidiaries, joint-ventures, associates or affiliates. RP transactions are an inter-firm agreement that may reduce costs and improve efficiency (Coase, 1937), and help businesses to fulfill their economic and financial needs (Gordon, Henry, Louwers, & Reed, 2007). The transaction is legal although some of the transactions are agreed at below or above market rates, and non-arm's length transactions. However, the existence of RP transactions draws attention to policymakers, enforcement authorities, private institutions, shareholders, and other stakeholders, in that such a transaction may be used to commit fraud or manipulate financial reports by firms, particularly large ones. The Enron and Adelphia accounting scandals in the U.S., KMK and Mailyard in China, and Satyam in India are such examples. These scandals expose the weakness of a control mechanism that is required in the form of corporate governance reforms, especially in the emerging markets in East Asia.

Reviewing such scandals, Rezaee (2005) found that Enron's Chief Financial Officer (CFO) and general partner used the firm's special-purpose entities to manipulate earnings and transfer cash, and Henry, Gordon, Reed, and Louwers (2007) found that Adelphia guaranteed related-party debt and provided extensive loans to executives. In China,

controlling shareholders of two Chinese listed firms utilized KMK and Mailyard as a tool to expropriate cash from them (Tong & Wang, 2008). Concerning Satyam's case in India, its board of director's decision to approve an acquisition of two entities related to the founder, chairman and CEO of the firm, resulted in the exposure of the accounting fraud (OECD, 2009).

These scandals shed light on abusive RP transactions involving senior management, executive and non-executive directors (Henry et al., 2007) or controlling shareholders (Dahya, Dimitrov, & McConnell, 2008; Wiwattanakantang, 2001). It is emphasized that these related parties are referring to individuals who have significant positions within the firm and play a substantial role in the firm's corporate governance. They can use their position, authority and power to influence business operations and decision-making processes. Without an effective check and balance mechanism or corporate governance control strategy, senior management may take advantage to utilize their power and authority to entrench their own interests (Fama & Jensen, 1983; Jensen, 1993). Executive managements or controlling shareholders are able to hide their personal interests within the transactions which on the surface appear to fulfill their firm's financial goals (Beasley, Carcello, Hermanson, & Lapides, 2000; Gordon et al., 2007). This makes it difficult to detect any abusive transactions.

The above argument is consistent with agency theory that emphasizes RP transactions raise both agency conflicts. Managers may use RP transactions to expropriate wealth from shareholders due to information asymmetry (agency conflict Type I), and controlling

shareholders, as a result of concentrated ownership could maximize their benefits at the expense of minority shareholders (agency conflict Type II) (Fama & Jensen, 1983; Jensen & Meckling, 1976). As a result, a firm's managers or controlling shareholders' involvement in any contract with related parties could be seen from two different perspectives; either it represents an efficient transaction or conflict of interest transaction (Gordon et al., 2007).

The 1997 Asian financial crisis exposed weaknesses in corporate governance practices and shareholder protection in many businesses in the East Asia region. During this particular crisis, the managers or controlling shareholders expropriated funds in order to survive and engaged in such actions as making improper transfers of cash or assets, purchasing or selling assets at inflated rate or making outright bailouts of failing subsidiaries. However, minority shareholders cannot prevent the improper conduct by managers or controlling shareholders. Since the financial crisis, much progress has been achieved and implemented over the past decade in developing effective laws and regulatory frameworks to curb abusive RP transactions, particularly in the East Asia region.

The structure of corporate governance has been reformed so that corporate governance best practice principles can be implemented, and company laws or statutes have been amended to deal with specific rules on transactions with relevant parties. For example, the amendment of the Malaysian Companies Act 1965 in 2007 was done to enhance the corporate governance structure and increase investor confidence. The Organization for Economic Co-operation and Development (OECD) and an Asian Roundtable on Corporate Governance (ARCG) have played significant roles in the corporate governance reforms as well as

establishing guides for monitoring and curbing such abusive RP transactions, focusing on disclosure and the board and or shareholders' approval systems in Asian countries.

The number of RP transactions in East Asia countries is expected to be high. The economic institutions, equity capital structure, corporate governance and legal system in those countries are conducive to RP transactions. Many firms in East Asia are dominated by block or substantial shareholding in the form of concentrated ownership, either through individuals, group of families, corporations or governments. Family members of the controlling shareholders are usually involved in management and governance of listed firms (Claessens, Djankov, & Lang, 2000) which increases the likelihood of transactions with related parties. The rise of centrally-administered and group-affiliated entities in some Asian countries also increase a possibility of RP transactions because the external market is inefficient. Furthermore, abusive RP transactions can increase due to: firstly, the lack of minority shareholder interest protection; and secondly, institutional ownership in some East Asian countries due to weak corporate governance practices.

Abusive RP transactions could lead firms to poor performance due to over-payment of assets, lower-selling price, or simply use financial services to the benefit of the related parties. The different price between the agreed RP transactions and the market price is the benefit gained by these parties. However, minority shareholders have suffered the setback, to bear the costs, whether in the form of one-off material expropriation or the slow expropriation of wealth via continuous RP transactions (OECD, 2009). Prior studies show that those firms engaged in RP transactions perform poorly (Chen & Chien, 2007) and

endure negative or abnormal stock returns (Cheung, Rau, & Stouraitis, 2006). Recent evidence from market perception studies on the consequence of RP transactions by Kohlbeck and Mayhew (2010) and Ge, Drury, Fortin, Liu, and Tsang (2010), find that RP transactions are negatively associated with firm valuation. Although Kohlbeck and Mayhew (2010) are based in the U.S.¹ and Ge et al. (2010) look at Chinese listed firms, their findings are consistent, suggesting that investors value related-party firms significantly less than non-related party firms prior to regulatory intervention.

Furthermore, Sherman and Young (2001) emphasize RP transactions increase the likelihood of aggressive accounting. Executive managements or controlling shareholders can manipulate the terms of a transaction and disclosure to their own personal advantage due to information asymmetry. The argument is a large number and higher magnitude of RP transactions will cause firms to report bias earnings in their financial statements, which will not reflect the firm's actual market value and lead to less accurate decision-making (Tucker, 2007). Abusive RP transactions by the controlling shareholders to obtain private benefits will lead to a deterioration in earnings quality (Tong & Wang, 2008; Wang, 2006). If the market participants and investors are aware of the potential for earnings manipulation through RP transactions, it is expected that the earnings parameter for firms that are involved in RP transactions should be less than those firms without such transactions. However, studies that addressed the effect of RP transactions on earnings quality are few, particularly in reference to the emerging countries in East Asia.

¹ The United States Congress responded to the recent accounting scandals by banning related party loans to officers and directors through the Sarbanes-Oxley Act (SOX) in 2002.

1.2 Research Motivations

This study is motivated by a number of issues. Firstly, there is the growing number of accounting crises and instances of alleged corporate fraud among high profile firms through manipulating RP transactions. The revelation of these scandals is evidence that organizational issues surrounding human conflict of interests² simply never end. Opportunistic senior management or controlling shareholders may misuse their position, authority and power to utilize the legal internal dealings as tools to maximize their own personal interests. Therefore, the managers or controlling shareholders may be reluctant to provide reliable information about such opportunistic transaction to investors. Consequently there is a need to examine the effect of RP transactions on earnings quality and firm valuation, because such research is limited.

Secondly, the exposure of the misused transaction involves a firm and its related parties, particularly among large firms increase interest of academic studies. They study to explore and examine the determinants that motivate firms to enter contracts involving related parties (Adhikari, Derashid, & Zhang, 2006; Atanasov, Black, Ciccotello, & Gyoshev, 2010; Berkman, Cole, & Fu, 2011; Chien & Hsu, 2010; Gallery, Gallery, & Supranowicz, 2008; Gao & Kling, 2008; Gordon, Elaine Henry, & Palia, 2004; Lin, Liu, & Keng, 2010; Lo, Wong, & Firth, 2010a; Yeh, Shu, & Su, 2012). Additionally, some studies attempt to determine a potential impact of RP transactions on specific economic consequences (Aharony, Wang, & Yuan, 2010; Chen, Cheng, & Xiao, 2011; Jian & Wong, 2010;

² Conflict of interest occur where senior management or executive directors (related parties) expropriate shareholders' wealth through: firstly, related party transactions (Agency Conflict Type I); and secondly, where controlling shareholders obtain a private benefit at the expense of minority shareholders (Agency Conflict Type II).

Kohlbeck & Mayhew, 2010; Nekhili & Cherif, 2011; Ryngaert & Thomas, 2012; Wang & Yuan, 2012). However, most studies have analyzed US and Chinese listed firms where data cannot be generalized to other countries in East Asia for several reasons, including differential of equity capital structure, corporate governance practices and shareholder protection. RP transaction research in many other East Asian countries is very limited and some of them are published in non-reputed or non-refereed journals. It is therefore timely to explore the impact of RP transactions in the East Asia region, particularly in the context of international economics and globalization.

Thirdly, the East Asian countries have been chosen because they are emerging market economies. Doing business in an inefficient external market for most East Asian countries provides incentives to utilize transaction with related parties as an alternative strategy to maximize the allocation of capital resources. Apart from this, institutional ownership and regulatory framework, poor corporate governance and lack of shareholder protection, mainly for minority shareholders (Claessens et al., 2000) in most listed firms in East Asia allows firms to engage in RP transactions. The post-1997 Asian financial crisis reforms to curb RP transactions in East Asia and improve governance are expected to enhance shareholder protection and rebuild investors' faith in RP transactions. It is important to explore evidence after considering these new developments as well as to reduce investors' perceptions of deep-seated accounting scandals that occurred a decade ago.

Fourthly, the amendment of the Malaysian Companies Act 1965 in 2007 included a ban on loan transactions with related parties. The ban on RP loans is aligned with the Sarbanes-

Oxley Act (SOX) in the U.S. which banned RP loan to officers and directors in 2002. However, noted firms still employed loan transactions as advances to or from related parties. I found that Hong Kong, Singapore and Thailand do not prohibit RP loans to related parties. This state of affairs requires further analysis to find which provision is the best in serving the interests of the market. Therefore, this study would seek evidence from both internal (managerial) and external (investors) perspectives.

Fifthly and finally, it is relatively difficult to detect abusive RP transactions because the nature of such transactions is valid and fulfill business's needs. And yet RP transactions constitute a major cause of audit failure (Beasley, Carcello, & Hermanson, 2001). Gordon et al. (2007) reveal that firms' intention to manipulate their financial reports through RP transactions influences them to appoint auditors with whom they have a relationship. However, there is no further research to test the argument, particularly in the context of tenure auditor-client relationship. Previous studies such as those by Gallery et al. (2008) and Gul, Kim, and Qiu (2010) have found that large audit firms³ can play significant roles in mitigating the negative impact of RP transactions. I argue that audit firm size is not in itself enough to assess the close relationship as stated by Gordon et al. (2007). Hence, in this study, I will control the effect of the tenure of auditor-client relationship, in addition to audit firm size.

1.3 Research Question

Manipulation of RP transactions in East Asian companies may be associated with existing checks and balances in power structures among senior executives due to poor corporate

³ Audit quality is measured by the size of audit firms, either large or small businesses.

governance monitoring mechanisms (Fama & Jensen, 1983). The corporate structure, economic institutions and legal system in those countries (Claessens et al., 2000) are exposed to RP transactions. The concentration of ownership by controlling shareholders and involvement of family members in their management or ownership also increases the likelihood of transaction between firms and related parties. The controlling shareholders or executive directors may utilize RP transactions as a tool to expropriate shareholders' wealth by hiding dishonest or illegal transactions. Previous evidence shows that RP transactions affect the earnings quality and firm's value (Ge et al., 2010; Kohlbeck & Mayhew, 2010).

However, most studies focused on disclosures, whether the firms disclose or do not disclose their RP transactions, and a data set being used may be influenced by the investors' perceptions of the Enron accounting scandal. Therefore, this study raises question, whether the magnitude and abnormal (magnitude change) RP transactions are associated with managers or controlling shareholder's behaviors in managing earnings? Do investors perceive that magnitude and abnormal RP transactions are harmful to a firm's wealth, thus they value lower for the firms engaged in RP transactions? Are complexity types of RP transactions affecting earnings quality and valuation of listed firms in East Asia? After considering the corporate governance reforms and amendments to the regulatory framework over the past decade in the East Asia region, this study asks specifically the following questions:

1: Is there a significant relationship between RP transactions (based on magnitude and abnormal measures) and earnings quality (based on discretionary accruals and performance-based discretionary accruals)?

1a: Is there a significant relationship between the types of RP transactions (RP complex, RP simple and RP loan) and earnings quality (based on discretionary accruals and performance-based discretionary accruals)?

2: Is there a significant relationship between RP transactions (based on magnitude and abnormal measures) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness)?

2a: Is there a significant relationship between types of RP transactions (RP complex, RP simple and RP loan) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness)?

1.4 Research Objectives

The main objective of my study is to determine the effect of RP transactions on earnings quality and firm valuation in East Asia. I also investigate the effect of specific classifications⁴ of RP transactions on earnings quality and firm valuation. I determine the effects of RP transactions on earnings quality being proxied by discretionary accruals. Additionally, I examine the effects of RP transactions on firm valuation as proxied by firm performance, value relevance and informativeness of earnings. The specific objectives of this study are as follows:

- (i) to investigate the relationship between RP transactions and types of RP transactions (RP complex, RP simple and RP loan) and earnings quality (based on discretionary

⁴ We use the classification of related party transactions developed by Kohlbeck and Mayhew (2010), i.e. RP complex and RP simple transactions. **RP complex** refers to complex transactions that include related business, unrelated business, overhead and stock transactions. **RP simple** refers to straight-forward transactions that involve relatively few financial statement accounts and related parties. Simple transactions include loans, guarantees, borrowing, consulting, legal services and leases (Kohlbeck & Mayhew, 2010).

accruals and performance-based discretionary accruals) of firms in East Asian countries.

- (ii) to investigate the relationship between RP transactions and types of RP transactions (RP complex, RP simple and RP loan) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness) of firms in East Asian countries.

1.5 Significant Contributions to the Topic

This study contributes to earnings quality and RP transactions (accounting) literature and the public policy debate in several ways. This study extends the usefulness of agency theory in understanding two types of agency conflicts. Agency conflict can be categorized into two types. With respect to RP transactions, the agency conflict type I refer to conflict of interest among executive managers who want to personally benefit from expropriating wealth from shareholders. Agency conflict type II refers to the conflict of interest among the controlling shareholders who wish to expropriate wealth at the expense of minority shareholders. The results of this investigation will establish an understanding of agency theory regarding the use of RP transactions by opportunistic managers or controlling shareholders in East Asian businesses.

This study contributes to the literature on earnings quality by building on the research of Cheung et al. (2006), Munir and Mohd-Saleh (2009), Jian and Wong (2010), Aharony et al. (2010) and Chen et al. (2011). It examines the link between RP transactions and earnings quality. The work of Cheung et al. (2006), Jian and Wong (2010), Aharony et al. (2010) and

Chen et al. (2011) examine the association between RP transactions and real operating earnings management, in which RP transactions are structured for tunneling or propping up firm's wealth. This study shifts the real operating earnings management into accruals management because evidence from prior studies is limited. This study only found a mix of evidence for associations between RP transactions and discretionary accruals in non-refereed studies by Munir and Mohd-Saleh (2009), Kuan, Tower, Rusmin, and Van-der-Zahn (2010), and Jian and Wong (2010). This study also extends the measurement of RP transactions by using abnormal (magnitude change) RP transactions instead of only transaction magnitude. The abnormal measurement is consistent with Aharony et al. (2010). This study believes that the abnormal could strengthen the magnitude-based evidence. The study also contributes to the RP transactions and accrual management literature by providing cross-country evidence for East Asia as since most prior studies only focused on an individual country⁵. Thus, the evidence would contribute to a broader international perspective.

The thesis provides current empirical evidence to understand the effect of RP transactions on firm value and firm performance (Tobin's Q) in several ways. Firstly, Dahya et al. (2008), Kohlbeck and Mayhew (2010) and Ge et al. (2010) use a discrete measurement for RP transactions, where they use an indicator variable to represent firms' disclose or non-disclosure of RP transactions due to certain circumstances. This study believes that it is difficult to judge whether RP transactions are abusive based only on firms' disclosure and non-disclosure of such a transaction. RP transactions are highly relative. Therefore, the measurement should consider numbers and magnitude (thresholds) of the transaction.

⁵ Cheung et al. (2006) use data of Hong Kong listed firms, Munir and Mohd-Saleh (2009) use data of Malaysia listed firms, Aharony et al. (2010), Jian and Wong (2010), and Chen et al. (2011) use data of Chinese listed firms, and Kuan et al. (2010) use a data set from Indonesia.

Furthermore, in the context of cross-country studies, the listed firms' disclosure of RP transactions in financial reporting is dissimilar due to different disclosure requirements in each country. Nevertheless, the disclosure requirements in all countries set a certain threshold (magnitude) as a benchmark to disclose RP transactions. This study believes that the magnitude (thresholds) of RP transactions would be more precise in determining their impact. For this reason the thesis extends the measurements of the above prior studies by using magnitude and abnormal (magnitude change) RP transactions.

Kohlbeck and Mayhew (2010) and Ge et al. (2010) used information disclosed in financial reports for the year that is close to the revelation that RP transactions have been used opportunistically to commit fraud. Financial scandals concerning RP transactions were reported in the media regularly and this may have increased market sensitivity to RP transactions. Investors may become conservative and develop negative perceptions about financial practices. I argue that the negative effect of RP transactions on firm valuation may be influenced by such events. It is also consistent with Kohlbeck and Mayhew (2010) who were concerned that the revelation of such scandals may limit the generalization of their findings. I conduct this study by using information disclosed in financial reports for the period 2007 to 2010. The information is about a decade since the revelation of the scandals and hence is considered ample time to limit the influence of the events. In addition, many statutory laws and regulations and corporate governance reforms in the East Asia region have been implemented in the last decade, specifically for preventing abusive RP transactions. The implementation of the amendments and the reforms are expected to enhance shareholder protection, and may rebuild investors' confidence in RP transactions.

This empirical evidence will contribute substantially to the RP transactions and firm valuation literature.

Thirdly, this study will also contribute to the literature on RP transactions with reference to informativeness of earnings. There is no research to date except Wang and Yuan (2012) on the effect of RP transactions on earnings informativeness, mainly in the context of East Asia. Wang and Yuan's (2012) findings are limited to Chinese listed firms and therefore, the empirical results from this study contribute significantly to our better understanding of the effect of RP transactions on the informativeness of earnings.

This study also agrees with Gordon et al. (2007) who argued that those firms manipulating financial reports using RP transactions are more likely to appoint auditors with whom they have a relationship. However, there is no subsequent research empirically confirming this contention. This study argues that the closed auditor-client relationship can be developed through longer audit engagement. As a result, the auditor may become complacent and not diligent enough about querying the clients, senior management or controlling shareholders regarding RP transactions. The auditor-client relationship was not pursued in previous RP transactions' studies⁶. However, this study only includes the auditor-client relationship as a control variable due to time limitation.

Despite the significance and magnitude of RP transactions and their effects on earnings and firm valuation, very little substantive research has been undertaken to understand if such RP

⁶ Gallery et al. (2008), and Chien and Hsu (2010) examined the roles of audit quality in curbing abusive related party transactions. They measured audit quality according to size of audit firm, which this study believes will not reflect a close relationship between auditor and clients.

transactions affect a firm's market valuation in East Asia. Research in the U.S. such as Gordon et al. (2004), Gordon et al. (2007), Kohlbeck and Mayhew (2010), and Ryngaert and Thomas (2012) cannot be generalized across emerging countries because in the U.S., the disclosure standard is higher, corporate governance is more effective and minority protection is much stronger than in emerging economies. In Asia the majority of research focuses on firms in China, where most businesses are government or state-controlled. The research could not be generalized to other Asian countries because of difference in the equity capital structure and market. This study contributes to this important issue by extending prior research using a large sample of listed firms consisting of 1,269 firm-year observations from four East Asia countries, namely China, specifically Hong Kong, Malaysia, Singapore and Thailand. In addition, this cross-country analysis will contribute substantially to the literature at a broader international level. Dahya et al. (2008) is the only study to date that examined the impact of RP transactions using a cross-country analysis⁷. They analyze 22 countries with a limited sample from each country. This study uses one-third of the available population from each country⁸ to ensure a representative sample.

1.6 Structure of the thesis

This thesis is organized as follows. The following chapter, Chapter 2 discusses RP transactions in more detail, explains two types of agency conflicts in an Agency Theory, i.e. Agency Conflict Type I and Agency Conflict Type II to predict that opportunist controlling shareholders, directors and senior managers may utilize RP transactions to gain a personal benefit. This chapter also discusses a potential that RP transactions are used for tunneling or

⁷ Most studies have focused on a single country (see Villalonga & Amit, 2006; Kohlbeck & Mayhew, 2010; Ryngaert & Thomas, 2012; Jian & Wong 2010; Aharony et al., 2010).

⁸ The available firms that fulfill the requirements are discussed in Chapter 5.

propping up activities. Chapter 3 discusses the institutional and regulatory background that provides the basis of RP transactions in East Asia. This chapter also reviews the literature to identify determinants of RP transactions, and the incentives that encourage firms to engage with related parties. Chapter 4 discusses the impact of RP transactions and develops directional hypotheses developed for this study. The first section reviews the links between RP transactions and earnings quality, and the second section reviews the effects of RP transactions on firm valuation. Then, I develop two main hypotheses: (1) the prediction of links between RP transactions and discretionary accruals (earnings quality); and (2) the prediction of associations between RP transactions and firm valuation.

I develop a research design and methodology of this study in Chapter 5. Chapter 6 presents Part I of the empirical results that discuss the effect of RP transactions on discretionary accruals (Discretionary Accruals and Performance Matched Discretionary Accrual). Chapter 7 presents Part II of the empirical results that discuss the effect of RP transactions on informativeness of earnings, earnings value relevance and firm performance (Tobin's Q). This part is based on the market valuation that considers investors' perceptions of RP transactions. Finally, Chapter 8 summarizes the results and draws the overall conclusions concerning the major themes covered in this research study.

Chapter 2

RP Transactions and Theoretical Framework

2.1 Introduction

Many large corporations have abused RP transactions and this has led to reported accounting scandals becoming an important issue in recent years. They have led to many corporate failures in the U.S. and other countries, including emerging economies in Asia. The scandals have highlighted abuses of RP transactions by executives, board members and controlling shareholders. Jensen and Meckling (1976) have stated that managers or controlling shareholders tend to appropriate their firm's resources for personal consumption via RP transactions. This agency issue emerges because of asymmetric information problems between external stakeholders and the firm's managers. Opportunist managers or controlling shareholders can execute RP transactions to conceal any personal conflict of interest behind the façade of an allowable transaction. Consequently, RP transactions could represent both efficient transactions and opportunistic transactions. The business environment, particularly in emerging East Asian countries, has witnessed the development of managers or controlling shareholders becoming closely involved in RP transactions.

This chapter examines the following themes. Section 2.1 discusses and defines the nature of RP transactions and the potential for conflict of interest to emerge. Section 2.2 discusses the fundamental theoretical outlines that underpin RP transactions so that the nature of efficient (even if illegal) opportunistic transactions is understood. Section 2.3 discusses RP

transactions that occur in East Asia. Section 2.4 reviews RP transactions as a source of tunneling or propping up the wealth of firms. Finally, the last section summarizes the main themes outlined in this chapter.

2.2 Nature of RP Transactions

The general reporting framework of RP transactions was established by the International Accounting Standard (IAS) 24⁹. IAS 24 is the basis for the establishment of financial reporting standards (FRS) in all countries, including those in East Asia. IAS 24 identifies the ‘related party’ as that which can exercise control or significant influence over the operations or financing policies of the other party. Related parties can be directors, officers, managements of firms, and shareholders of their affiliates. Entities under common ownership or controlled are deemed related parties. The contracts between a firm and its subsidiaries, associates or subsidiaries of a parent firm are also classified as transactions with related parties. It is stated under Pursuant to IAS 24.9, IAS 24 that a party is related to an entity if the following conditions apply:

- (a) Directly, or indirectly through one or more intermediaries, the party;
- (b) The party is an associate of the entity;
- (c) The party is a venturer in which the entity is a joint venture;
- (d) The party is a member of the key management personnel of the entity or its parent;
- (e) The party is a close member to the family of any individual referred to in (a) or (b);

⁹ The IAS is issued by the International Accounting Standard Board (IASB).

- (f) The party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such an entity resides with, directly or indirectly; any individual referred to in 9d) or (e), or;
- (g) The party is a post-employment benefit plan for employees of the entity, or of any entity that is related to that entity.

Meanings of relatedness can also extend to the ownership relationship. In terms of individual interest, a controlling shareholder might have a direct influence, yet his or her relatives could also be classified as being related parties. The threshold tiers of family relationships will include the next level of relationship. Here the first level includes spouse, brother, sister, mother, father, son, daughter or equivalent; and the second level involves cousins, in-laws, aunts, uncles or equivalent; finally the third level includes grandparent, grandson, or equivalent (OECD, 2009).

The International Accounting Standards Board (IASB) defines RP transactions as transfers of resources, services or obligations between related parties, regardless of whether a price is charged. RP transactions refer to any transaction entered into by the issuer or its subsidiaries, which involve the interest, direct or indirect of related parties. RP transactions also include any group transactions between a firm and its related entities, such as affiliates, subsidiaries, associates, joint ventures, principal owners and directors. RP transactions can be recurring transactions, characterized by necessary day-to-day operations of a listed issuer or its related entities. The transaction that requires recurring agreement usually involves sales or purchases of services, goods, assets, including raw materials to be used for the

production of goods. The price of the transaction might be charged (transfer pricing) higher or lower than a market price (Aharony et al., 2010). However, others can include significant one-off transactions with related parties that may be executed at any amount differing from market prices.

There are many forms of RP transactions that take place including that where land and/or property is transferred through the sale or purchase transaction, asset acquisition, asset sales, equity sales and transactions that result from a trading relationship. It can also comprise transactions that involve cash payment made to the controlling owners (Cheung et al., 2006; Munir & Mohd-Saleh, 2009). The most common RP transactions are loan activities such as personal loans to directors, officers, controlling shareholders and other insiders. Opportunistic related parties will benefit from the loan typically when these are being charged at below market interest rates (Berkman, Cole, & Fu, 2009). For example, executives who have less ownership of shares in a firm will benefit from such loans to increase their ownership level (Gordon et al., 2004; Kohlbeck & Mayhew, 2010). As another example, senior managers and executive directors are able to expropriate wealth and benefits from the shareholders by allocating funds as salaries, allowances and other compensation for their own personal accounts (Kohlbeck & Mayhew, 2004). A firm can also use this legal transaction to transfer a firm's assets to its controlling shareholders at non-market prices, and provide loan guarantees using the firm's assets and other resources (Chien & Hsu, 2010; Johnson, Boone, Breach, & Friedman, 2000).

Some studies recognize that the nature of every type of RP transaction is distinctive, and the firm can use it differently to fulfill certain incentives. These analyses classify RP transactions into several categories with certain characteristics. Kohlbeck and Mayhew (2010) divide RP transactions into two broad classifications, one where the transaction is simple or another is strategic, depending on the complexity of transactions¹⁰. Cheung et al. (2006) and Cheung, Jing, Lu, Rau, and Stouraitis (2009) classify RP transactions into two categories of expropriation, potentially tunneling and propping transactions¹¹.

RP transactions usually involve internal arrangements and allow opportunist-related parties such as directors, managers or controlling shareholders to take advantage of the transaction within the group for their personal benefit. This can cause conflict of interest where the controlling shareholder can use RP transactions to produce misleading business operating results that would affect minority shareholders' wealth (Larcker, Richardson, & Tuna, 2007). There are two different theories behind the transaction. Either it demonstrates a potential for managerial or directorial conflict of interest that could economically damage the firms, or it is an efficient transaction that fulfills the firm's economic needs (Villalonga & Amit, 2006). These two contrasting views will affect the potential costs and benefits of the transactions

¹⁰ The complexity of RP transactions differentiates the nature of the transaction. Thus, the complexity differentiates a risk RP transactions are used opportunistically to expropriate. Kohlbeck and Mayhew (2010) define complexity as transactions that typically involve a number of financial statement accounts and related parties, often include a number of conditions that impact on financial statements in less obvious ways. It includes investments in a related or unrelated business, overheads and stock transactions. These transactions usually involve long-term arrangements or recurring transactions. RP simple transactions refer to a straight-forward transaction that involves relatively few financial statement accounts and related parties; and are typically avoidable in the sense that a third party could replace related parties with little observable consequences. RP simple transactions include loans and borrowing, guarantees, legal or business consulting, and renting or leasing.

¹¹ Cheung et al. (2006) categorized RP transactions into several types such as transactions, which could result in the expropriation of wealth from minority shareholders, transactions that take advantage of minority shareholders, and transactions that are carried out for strategic reasons and are assumed to have no expropriation rationale. The concept of tunneling and propping up will be discussed in section 2.4.

for shareholders and the related parties in different ways. The next section discusses the theoretical framework that underpins the issue.

2.3 Theoretical Framework

Agency theory explains human behavior in an organization, specifically the relationship existing as a contract when one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent (Jensen & Meckling, 1976). A basis of the relationship is a separation that exists between management and ownership, in which the firms are managed by people who do not own the firm. This kind of business structure is common among large publicly listed firms because the owners appoint managers who have minimal shareholdings within the organization, and the owners have minimum impact on daily business operations.

The separation of ownership and control contract leads to information asymmetry issues; therefore, senior management and executive directors are responsible and accountable for preparing information for stakeholders. Failure to monitor the management may lead to inefficient resource allocation and to some extent, earnings management and fraudulent financial reporting. Thus, agency theory postulates that the modern diffused ownership pattern of businesses results in the opportunistic behavior of managers due to them having managerial conflicts of interest (Jensen, 1993; Jensen & Meckling, 1976). In the case of RP transactions this may involve both types of agency conflict, Type I and Type II.

Agency problem Type I explains a conflict of interest between managers (agents) and shareholders (principals) where managers are able to maximize their wealth at the expense of shareholders by employing RP transactions. The spirit of the contract is a convergence of interest between managers and shareholders, where the managers are (it is assumed) acting on behalf of the firms to maximize shareholders' wealth. If managers are assumed to be opportunists, there is good reason to believe that the managers will not always act in the best interests of the shareholders. Managers' opportunism is a key driver in the misappropriation of assets and misleading financial reporting. Senior or executive management behavior will affect the preparation of the financial reports where they elect to choose alternative accounting practices that hide any financial benefit to themselves (Isa, 1997). Without effective internal controls, senior managers may behave to maximize their personal interests, resulting in the decision-making process being diverted from shareholders' interests (Acharya & Johnson, 2010). Prior research supports this argument by showing evidence that managers manipulate earnings to fulfill certain objectives such as avoiding losses or declining earnings (Burgstahler & Dichev, 1997; Mohd-Saleh, Iskandar, & Rahmat, 2005), and initial public offerings (Aharony, Lin, & Loeb, 1993; Aharony et al., 2010; Cheng & Chen, 2009).

Agency problem Type II explains the conflict of interest between the controlling shareholders and minority shareholders. The existence of controlling shareholders, specifically by a group of families, can reduce information asymmetry (agency conflict Type I) due to the separation of ownership and control (Fama & Jensen, 1983; Jensen & Meckling, 1976). When large stockholders control firms, the main problem is no longer the

conflict of interest between management and shareholders, but preventing principal shareholders from exploiting minority shareholders (Shleifer & Vishny, 1986). The controlling shareholders can expropriate the wealth of minority shareholders through tunneling, propping or manipulating RP transactions. In recent years, the exploitation of minority shareholders by large shareholders has attracted scholars' widespread attention and becomes a major research topic in RP transactions.

The concentration of ownership structure is a major contributor to agency conflict Type II. Concentrated ownership provides controlling shareholders with the authority and power to dominate decision-making processes within the firm. In addition, the management of the majority controlled firms, mainly in the family firm, is usually related to controlling shareholders or their family members (Shleifer & Vishny, 1986; Villalonga & Amit, 2006). Controlling shareholders may benefit from their roles and positions as there are incentives for them to hamper minority shareholders' interests. In principle, however, the potential of concentrated ownership could result in agency conflict Type II, depending on the convergence and/or entrenchment effect.

The convergence effect is based on a managerial ownership hypothesis. The managerial ownership hypothesis suggests that ownership by executive management and senior directors could lead to convergence of interests between managers and shareholders. The manager and the owner will use the business to achieve convergence objectives. Here, concentrated ownership can facilitate the alignment of interests between controlling and minority shareholders (Lins, 2003; Mitton, 2002). It may function as a credible commitment

made by controlling shareholders to retain a good reputation and not betray the interests of minority shareholders (Gomes, 2000).

In contrast, entrenchment hypothesis suggests the managers' interest would be inverse when the ownership becomes substantial that allow them to control firm (Morck, Shleifer, & Vishny, 1988). Concentrated ownership provides controlling shareholders with an incentive and/or opportunity to divert firm resources at the expense of outside shareholders (Fan & Wong, 2002; Johnson et al., 2000). An entrenched controlling shareholder can utilize their effective control over the firm to engage in self-dealing transactions, which allow them to extract the benefits emanating from private control (Morck et al., 1988; Shleifer & Vishny, 1989). Such entrenched controlling shareholders have an incentive to cover up their self-serving behaviors, or to limit related information leakage, by withholding unfavorable information or be selective in disclosing such information. Therefore, they are able to camouflage their self-serving behaviors, and/or opportunistically time the release of value relevance and private information to the market. Studies have indicated that the entrenchment effect becomes more apparent when controlling shareholders increase their ownership level within a range of 25% to 50% (Wiwattanakantang, 2001).

2.3.1 RP Transactions: Efficient versus Opportunistic Transactions

Aligned with agency theory, this study draws attention to that firm's ownership, where a weak governance control mechanism can create incentives and opportunities to enter RP transactions. Increased ownership increases the ability of insiders, like managers or controlling shareholders, to engage in RP transactions with less oversight. While few

factors, including the ownership as well as the needs of the daily operation of the firms can motivate RP transactions, ex-ante, this study cannot unambiguously predict the direction of the impact. A main troubling aspect of these transactions is that the subtleties underlying the transactions are often difficult to identify or audit (AICPA, 2001). Henry et al. (2007) emphasize that RP transactions are not necessarily a mechanism for fraud, however, transactions between a firm and its own managers, directors, principal owners, controlling shareholders or affiliates are usually diverse and complex. While executives can clearly structure RP transactions for personal interest and not that of their business, such transactions are not necessarily illegal, only perhaps misguided. Thus, agency theory suggests two possible motivations behind the use of RP transactions. One such motivation described is contracting efficiency, which could work against the minority shareholders' advantage if it translates into good operating results. Another motivation is conflict of interest if it is opportunistically used to expropriate wealth from minority shareholders.

2.3.1.1 Efficient Transactions

According to the efficiency hypothesis, the nature of all RP transactions is not abusive, and cannot be classified only as dealings serving fraudulent or deceptive purposes since the dealing as sound business fulfills a firm's economic operations. This view is based on the argument that RP transactions do no harm and may give a benefit to the shareholders (Abdul-Wahab, Haron, Lok, & Yahya, 2011; Jian & Wong, 2010). Firms use RP transactions as a method to maximize capital resource allocation, reduce transaction costs and improve return on asset. RP transactions could be viewed as representing internal dealings, an alternative to contractual or market exchanges, and able to reduce transaction

costs and overcome difficulties impairing production of goods and/or services. RP transactions can efficiently fulfil the underlying needs of a firm such as service providers with in-depth firm-specific knowledge. For example, the firm engaging the related party to provide the service could be more effective than hiring an outsider. The executive director possesses an extensive knowledge of the firm, and in this way information asymmetries may be reduced and contracting enhanced (Gordon et al., 2004). Therefore, efficient RP transactions could reduce monitoring and operating costs, and ensure a continuity of the firm's daily operations.

Apart from this, RP transactions are important for businesses in the emerging East Asia marketplace. A firm can use contracting with related parties as an alternative due to an inefficient market (Khanna & Palepu, 1997). When a firm or related entity has financial difficulties and external sources of funds are uncertain, the group of businesses can use the internal financial market to reallocate capital among its members, ensuring that welfare and economic benefits are maximized by all firms (Khanna & Palepu, 1997). Thus, RP transactions function where the internal market helps firms to allocate resources efficiently. In addition, the internal contractual arrangement also becomes efficient when there is insufficient information for an external contract (Larcker et al., 2007), and makes it possible to share technological skills and advertising that reduce transactional costs (Bharath, Sunder, & Sunder, 2008; Larcker et al., 2007). As long as RP transactions efficiently fulfill firms' business needs, the transaction does not betray the interests of shareholders (Larcker et al., 2007). However, many prior studies do not support this view.

2.3.1.2 Conflict of Interest Transactions

The conflict of interest view states that RP transaction is opportunistically used, which compromises management's agency responsibility to shareholders as well as directors' monitoring function (Gordon et al., 2004). Opportunistic parties like controlling shareholders or managers of a firm can use the diverse and complex nature of RP transactions to maximize their personal needs at the cost of minority shareholders. This conflict of interest view is consistent with agency issues raised by Jensen and Meckling (1976), who suggest RP transactions are potentially harmful to the interests of minority shareholders (Cheung et al., 2006; Gordon et al., 2004; Kohlbeck & Mayhew, 2010).

The main concern about RP transactions clearly focuses on the non-arms-length nature of the transactions. As an internal form of dealing, a business transaction between a firm and its related parties normally distracts from an arm's length transaction that favors the involved parties. The non-arms-length transaction gives rise to potential agency costs because related parties can profit from transactions at the firm's or its other stakeholders' expense. In contrast, according to his exploratory study, Pizzo (2011) states that an implicit assumption behind conflict of interest theory is that RP transactions could have been carried out with a related party at arm's length, but the financial statements may be misleading, or even fraudulent due to manipulation. The transactions have been conducted between two firms or entities appearing to be independent, but the relationship affects the substance of the transaction.

Controlling shareholders or managers could benefit from their positions through buying assets, goods or services from related entities at higher prices or transferring assets from a firm to other entities at low prices. For example, a firm can lease a premise from a firm controlled by a director of the firm, and pay a fee greater than what would be charged by an unrelated entity. In this case the director may expropriate some of the firm's wealth through related entities (Kohlbeck & Mayhew, 2004). The cost incurred in the transaction would reduce an amount of earnings that could benefit the other stakeholders, especially minority shareholders. Therefore, the conflict of interest view is concerned with the transaction between related parties being for deceptive or fraudulent reasons rather than genuine business transactions. This kind of internal dealing must be regarded with suspicion and the economic rationale is inevitably questioned. The majority of prior research finds evidence supporting the view of conflict of interest.

Previous studies have attempted to corroborate these two views by investigating the roles of RP transactions in various scenarios. For example, they investigate a potential of RP transactions used in earnings management (Chen et al., 2011; Gordon & Henry, 2005; Jian & Wong, 2003), and tunneling or propping up (Cheung et al., 2006; Kali & Sarkar, 2011; Peng, Wei, & Yang, 2011; Wang & Xiao, 2011). Other studies examined the effect of RP transactions on firm valuation and performance (Dahya et al., 2008; Kohlbeck & Mayhew, 2010). These findings are aligned with the view that suggests RP transactions are tools that accomplish conflict of interest objectives rather than efficient transactions. Ryngaert and Thomas (2012) find that *ex-ante* RP transactions are genuine or effective transactions but the presence of counterparty as a related party (*ex-post*) initiates a conflict of interest

transaction. However, prior studies such as Aharony et al. (2010), Lin et al. (2010), and Abdul-Wahab et al. (2011) demonstrate that potential conflict of interest can be reduced or turn into an efficient transaction by establishing a good governance structure. Gallery et al. (2008) also suggest of the role of external monitoring by a high quality audit, while Atanasov et al. (2010) and Ge et al. (2010) emphasize the enforcement of effective regulations to reduce potentially corrupt RP transactions.

Conflict of interest and efficient transaction theories are criticised as being affected by inconsistencies or deficiencies, and not able to explain different kinds of cases. For example, the conflict of interest theory is more sensitive to social needs such as minority shareholder protection and capital market fairness and efficiency (Pizzo, 2011). Thus, Pizzo (2011) emphasizes that emerge a fundamental concept suggesting not all RP transactions are the same, and only some categories may be considered harmful. Ryngaert and Thomas's (2012) findings may support the point where investors do not perceive RP transactions are abused in all stipulations, particularly in a firm with good corporate governance and effective regulations. On the other hand, Pizzo (2011) criticizes the efficient transactions view that the transaction does not seem a persuading alternative than a normal arm's length transaction. Empirical evidence is not always supportive of its premise and, indeed, the idea that RP transactions consistently satisfy economic needs may be quite naive. Pizzo (2011) adds that even risks associated with these dealings are considered a potential harm to shareholders and the transactions undermine their confidence in the capital market. As the efficient transaction view has been of very little influence, therefore, the rules affecting RP

transactions' disclosure and monitoring them have been largely influenced by the conflict of interest theory.

2.3.2 *RP transactions and Potential of Abusive*

Based on the above discussion, the existence of RP transactions is deemed to increase a firm's risk due to managers potentially using the transaction to abuse shareholders' interest. RP transactions are lawful¹² and are not necessarily an indication that a firm is expected to engage in greater earnings management or fraudulent reporting (Gordon & Henry, 2005; Henry et al., 2007). However, opportunistic parties can exploit RP transactions to gain a private benefit by concealing their personal interest behind the legal transaction. Related parties also can manipulate the disclosure of RP transactions easily because of its information asymmetry. Therefore, RP transactions expose shareholders to potential wealth expropriation by the directors, managers or controlling shareholders. For example, Henry et al. (2007) suggest that managers or controlling shareholders most frequently use loans for the benefit of related parties, unapproved or non-existent payments to business representatives for services, and sales of goods. Here the existence of the relationship is not disclosed and a fraud is committed. Johnson et al. (2000) also emphasize that the diversion of corporate resources from the firm or its minority shareholders to the controlling shareholder can be substantial, where some tunneling, particularly in emerging markets, may take the form of theft or fraud.

¹² RP transactions are legitimate activities and serve practical purposes because: (1) they are recognized in corporate and taxation laws; (2) they have their own standards for accounting treatment; and (3) systems of checks and balances to make sure they are conducted properly and fairly.

The General Accounting Office (GAO, 2003) has identified RP transactions as one of the nine major reasons leading firms to restate their financial statements. It is relatively difficult to distinguish abusive RP transactions in the hidden personal interests of the related parties in such a transaction that on the surface fulfills a business's daily operations (AICPA, 2001; Johnstone & Bedard, 2004). The auditor's failure to discover corrupt RP transactions has been documented as occurring at a high rate (Beasley et al., 2000; Gordon et al., 2007). Opportunistic parties can comfortably exploit this advantage to execute transactions and manipulate financial reports in their favor. Consequently, many accounting manipulations through RP transactions are only identified at the critical stages, when the firms become fully financially compromised. The Enron case, for example, is a classic instance of a giant corporation that was apparently healthy and received clean audit report, but it instantly collapsed because of related parties' manipulation (Chaney & Philipich, 2002; Rezaee, 2005).

2.4 RP Transactions in East Asia

RP transactions are very common in East Asian countries. There are many factors that influence the amount and nature of RP transactions. Typically, a majority of East Asian conglomerates are likely to be dominated either by a family or the state. This concentrated ownership allows controlling shareholders to dominate the operations of firms, where they usually occupy key managerial positions (Sarkar, Sarkar, & Sen, 2008). Family members of the controlling shareholders often occupy the top management positions, including senior management, chief executive officer and board member. These kinds of family business groups and the informal nature of business relationships are typical in Indonesia, South

Korea, Hong Kong, Singapore Malaysia and Thailand (Claessens et al., 2000). This concentrated ownership with substantial rights differentiates the ownership structure of many firms in East Asia countries compare to Western countries. Despite concentrated ownership, shares of many Western firms are widely dispersed (Sarkar et al., 2008). Furthermore the controlling shareholder also has a substantial controlling ownership in other entities or affiliates in the groups. The dominant control structure provides better opportunities for a firm to deal with related members of the group, especially when some of the entities complement or exist to support the operations of others. However, these affiliations formed under the umbrella of common ownership can also be exploited as needed because the structure enables controlling shareholders to execute RP transactions and make it possible to expropriate the wealth of minority shareholders (OECD, 2009).

RP transactions may play an important role as an alternative market among groups of firms in East Asia. These groups can use RP transactions to maximize their capital resources effectively, benefit from more opportunities in business while groups of firms can obtain financial support from members of the group when outsource funding is difficult to secure. Transactional cost is high when external markets are not efficient (Coase, 1937). The internal market that is established within group firms could improve efficiency and communication, create long-term business relationships, and reduce uncertainty in the business environment. As a result, this internal market could reduce the transaction costs of the entire group firms (Khanna & Palepu, 2000a).

Studies have shown that RP transactions are prevalent among group firms, particularly group affiliates (Bae, Baek, Kang, & Liu, 2012; Bae, Kang, & Kim, 2002; Baek, Kang, & Lee, 2006; Gao & Kling, 2008; Gordon et al., 2004). Nevertheless, the controlling shareholders can take advantage of the group structure and RP transactions to realize their personal conflict of interest. The prospect of incomplete information in the external market due to information asymmetry can be employed by opportunistic parties to manipulate RP transactions because they have options to disclose, hide or manipulate such transactions in their financial reports. Therefore, the internal market that is set up within the complex ownership and control structure within group-affiliates firms may lead to greater abuse of RP transactions.

Most developing countries in the East Asia region are notorious for having poor governance systems and laws for protecting the wealth of minority shareholders (Claessens et al., 2000; Johnson et al., 2000; Mitton, 2002). Without any other large shareholder that might perform monitoring activities, the controlling shareholders can benefit at the expense of minority shareholders. During the 1997 Asian financial crisis, for example, minority shareholders could only watch as firms tried to expropriate funds in order to remain viable and engaged in such actions as making improper transfers cash or assumptions of debt, purchasing assets at inflated prices, and making outright bailouts of failing subsidiaries (CFA, 2009). This expropriation problem is likely to be more severe in companies where the controlling shareholders are also in management teams and in countries where the legal protection and enforcement of laws are poor (Bebchuk, Kraakman, & Triantis, 2000). This argument links to that of Jensen and Meckling (1976) who contend that by holding a large ownership stake,

the controlling shareholders reduce expropriation costs by extracting private benefits. Nowadays, the minority shareholder's protections in East Asia countries may improve following many amendment or issuance of acts or regulations.

There have been many instances where RP transactions were abused by managers and controlling shareholders through tunneling resources away from investors in order to obtain personal benefit (Jian & Wong, 2010; Munir & Mohd-Saleh, 2009). For example, the case of Ho Hup Construction Company Berhad in Malaysia wanting to sell some land was not disclosed as an RP transaction. However, subsequent events revealed the related parties involved the sister-in-law of an ex independent director. In the case of Tradewinds (M) Berhad, 65% of receivables which were due from its related parties were not properly disclosed. In Indonesia, Sinar Mas Group's auditing firm KPMG reported numerous questionable RP transactions, including advances worth USD504 million made to subsidiaries, which in turn, paid USD182 million to buy tracts of land from the Widjaja family at a time when they told creditors they were facing a cash crisis, in 2001. Other instances of RP abuse involving KMK, Mailyard, Delong Firm and Nongkai in China and Satyam in India drew the attention of many parties, including shareholders, policy makers and standard setters. It appears that possible internal dealings were used to obtain a personal benefit (Hu, Shen, & Xu, 2009; Tong & Wang, 2008).

Managers and controlling shareholders that enact corrupt RP transactions will try to conceal them by manipulating earnings. As a result, the quality of earnings reported by the firms involved in (abusive) RP transactions may be misleading (Munir & Mohd-Saleh, 2009) and

does not reflect the actual market value of the firm. Despite the significance and magnitude of RP transactions and their effect on earnings quality, very little substantive research has been undertaken to understand if such RP transactions affect companies' earnings quality and market valuation. Research in the U.S. cannot be generalized to developing Asian economies because in the U.S. the disclosure standard is higher, corporate governance is more effective and minority shareholder protection is much stronger. In addition, in the U.S. firms, RP transactions usually involve firms and their directors, while in Asia RP transactions more often involve the firm and its affiliates, subsidiaries or joint ventures belonging to controlling shareholders, family members, directors and others. RP transaction research in China had grown rapidly, however, as a country that still possesses a state ownership model¹³, the findings cannot be generalized for all East Asian countries. This study contributes to this important issue by using a large sample of listed firms consisting of 1,269 firm-year observations from four important countries, namely Hong Kong in China, Malaysia, Singapore and Thailand.

2.5 RP Transactions as a Source of Tunneling or Propping Up.

There are three major issues concerning RP transactions and these are tunneling, propping up and earnings management. Johnson et al. (2000) define tunneling as a transfer of a significant proportion of the free cash flows from a firm or affiliated firm into a business in which they have large cash flow rights and controls. Overpayment for acquisition of assets is an example of transfer of resources that could benefit the involved related parties.

¹³ In China, the government remains the majority shareholder of almost all listed firms. Each industry will have one umbrella entity, often the ministry that regulates it, with a number of holding firms that operate nationally through subsidiaries, usually in partnership with local government. It is not uncommon for units of one government agency to hold tiny stakes in the business of another. Unlike privatization in most countries, the Chinese government, often through an asset-management firm, retains a substantial amount of ownership in the listed firm.

Propping up activity describes the scenario whereby a controlling shareholder or owner uses its own resources to manage the listed affiliate's earnings (Jian & Wong, 2010), usually in the form of cash-based RP transactions. Shareholders can obtain benefits from these activities, and indirectly reduce the risk of information asymmetry. The manager's or controlling shareholder's intention to expropriate firm's wealth through tunneling would be accompanied by earnings manipulation to conceal any corrupt activity (Gao & Kling, 2008). The expropriation of wealth through tunneling can take the form of cash flows, assets, equity or a combination of two or more of these firms' attributes (Atanasov, 2005)¹⁴. Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2008) also shed light in that RP transactions may provide direct opportunities for related parties to extract cash from listed firms through tunneling activities.

Studies done by Bertrand, Mehta, and Mullainathan (2002) and Baek et al. (2006) use indirect measurement to identify the existence of tunneling. Bertrand et al. (2002) use returns on the assets of group-affiliate businesses to industry-wide stocks. They interpret the results as a manifestation of tunneling of income from a more profitable firm to non-profitable ones within the group firms. Other studies regarding South Korea, namely Bae et al. (2002) and Baek et al. (2006) use investors' reactions to determine the existence of tunneling activities in businesses operating in South Korea's Chaebols market. They find

¹⁴ Cash flow tunneling includes sales of a firm's output at below-market prices to another firm in which the family or controlling shareholder has significant or complete cash flow rights, or over-payment for inputs purchased from such firms. Cash flow tunneling may also result in excessive salaries or perquisites for family members or insiders. Asset tunneling typically involves the transfer of a firm's assets to firms (usually) fully owned by the families or controlling shareholders, and it can significantly affect a firm's long-term ability to generate cash flows. Equity tunneling involves actions that benefit the families or controlling shareholders at the expense of a reduction in the value of the shares owned by the other investors. This includes, for example, sale of new shares to the families at a below-market price, delisting and taking a firm private, and the issue of loans to the families that would not have to be repaid if the associated business venture were unsuccessful (Atanasov, 2005).

consistent results that the share prices of South Korean firms fall if they are required to bail out or acquire a failing firm in the same business group.

Cheung et al. (2006) examine a large set of RP transactions between Hong Kong listed firms. The objective of their study is to identify the potential for both tunneling and propping up activities by controlling shareholders. The evidence empirically supports the contention that such corporate RP loans are more likely to lead to an expropriation of minority shareholders. Cheung et al. (2009) employed a sample of RP transactions between Chinese publicly listed firms and their controlling shareholders during 2001–2002. They find consistent results that could be interpreted as evidence of tunneling of minority shareholders rather than transactions with related parties based on an economic rationale. Both Bertrand, Johnson, Samphantharak, and Schoar (2008) and Wiwattanakantang (2001) identify tunneling activities among family control shareholders in Thai firms. They interpret this finding as the manifestation of tunneling income from more profitable firms in certain business sectors to a distressed one, often using miscellaneous and non-recurring gains and losses.

Studies show that corporate RP loans (Aharony et al., 2010) and RP asset sales (Gao & Kling, 2008; Jian & Wong, 2003) are a main form of tunneling particularly among Chinese publicly listed firms. Cheung et al. (2006) and Cheung et al. (2009) support their study with empirical data that corporate RP loans increase the likelihood of wealth expropriation of minority shareholders. Aharony et al. (2010) find tunneling via non-repaid net RP loan in the post-initial public offering (IPO), which indicates that a parent firm exploits minority

shareholders by not repaying outstanding corporate RP loans obtained from the IPO. Most prior studies such as Bertrand et al. (2002) and Cheung et al. (2006) found evidence that expropriation of assets occurred through tunneling by controlling parties and thereby compromising minority shareholders. It led to a reduction to the stock market value or stock returns for those firms engaged in such transactions (Bae et al., 2002; Baek et al., 2006).

Nevertheless, evidence on supporting propping up argument is very limited. Several studies have investigated propping up activities and suggested that under certain conditions, the existence of an internal market may improve a business's market value. Friedman, Johnson, and Mitton (2003) note that RP transactions can also be used as tools to prop up underperforming affiliated firms, particularly in countries with a weak legal and governance system. They provide evidence that explains propping up, in which the controlling shareholders use their private funds to benefit minority shareholders. Cheung et al. (2009) show evidence that propped up firms are more likely to have foreign shareholders and be cross-listed abroad compared to firms that are subject to tunneling. They also find that propped up firms tend to function worse in the fiscal year preceding the announcement of RP transactions.

Khanna and Palepu (2000b) analyze a sample consisting of an Indian business group and find that group affiliation adds value, but only for firms that are affiliated with the most diversified groups. Jian and Wong (2010) argue the high frequency of these types of transactions allows sellers to inflate earnings by shifting next period RP sales to a current period. They note that firms could use other types of transactions such as asset injections to

achieve propping up, but the transactions are much more infrequent and easier to detect. They also find that listed firms prop up earnings by using abnormal RP sales to their controlling owners. This activity is more prevalent among state-owned firms and in countries with weaker economic institutions and corporate governance mechanism. Significant cash transfers via RP lending occur from the listed firm back to the controlling owners after the propping up has initiated.

2.6 Summary and Conclusion

This chapter has explained the nature of RP transactions that are carried out to fulfill business needs and the best interests of investors. However, RP transactions are complex and it is difficult to detect if a transaction is corrupt and constitutes a potential conflict of interest. Many accounting scandals in East Asia countries such as K.M.K and Mailyard in China, Satyam in India, Widjaja Mas in Indonesia, and Tradewinds (M) Berhad in Malaysia may indicate RP transactions are used opportunistically by managers, directors or controlling shareholders to commit fraud or manipulate financial reports. This chapter also explains that RP transactions are important for corporations in East Asia, in that they make it possible for transactions to occur between connected and affiliated parties.

This chapter also discusses the theoretical framework that underpins the use of RP transactions in East Asia. The risks of abusive RP transactions increase due to two types of agency conflict; agency conflict Type I and Type II. The existence of controlling shareholders, especially among family groups can eliminate agency conflict Type I, but agency conflict Type II increases the risk of wealth expropriation because concentrated

ownership by controlling shareholders will compromise corporate governance practices. Based on the entrenchment effect, opportunistic controlling shareholders can expropriate wealth without proper monitoring. Therefore, agency theory shows that RP transactions can be either efficient or opportunistic in character.

RP transactions have always been studied according to two different views. According to the first view, RP transactions could be efficient transactions. The transactions do not harm the interests of shareholders and sound business exchanges fulfill companies' needs. According to the second view, RP transactions may imply moral hazard and be done by directors in order to expropriate wealth from shareholders. The existence of these transactions can create misleading statements in financial reports. Finally, this chapter reviewed the potential of RP transactions as tools to expropriate wealth from businesses through tunneling or propping up activities by managers or controlling shareholders.

Chapter 3

Institutional and Regulatory Background and Determinants of RP Transactions

3.1 Introduction

The motivation of firms to engage in corrupt RP transactions has become an important issue in financial accounting and auditing. The directors, managers or controlling shareholders may use RP transactions as tools to tunnel and expropriate their businesses' wealth. Opportunistic parties could manage their companies' earnings by using RP transactions for their own benefit. Over the last decade of research on RP transactions, empirical findings show the negative effects of these transactions. The evidence links RP transactions with a weak corporate governance mechanism, legal system and regulation as well as institutional ownership able to protect investors' interests (Atanasov et al., 2010; Ge et al., 2010; Gordon et al., 2004). This chapter explores the institutional and regulatory background governing RP transactions in East Asian countries. This chapter also reviews those determinants associated with firms, managers or controlling shareholders' manipulation of RP transactions.

This chapter is organized as follows. Section 3.2 discusses the institutional and regulatory background that regulates RP transactions. This discussion consists of institutional ownership, rules and regulation for disclosure requirements, legal provisions, and stock exchange listing requirements, shareholder protection, and corporate governance reforms. Section 3.3 discusses the influences on firms, directors, managers or controlling shareholders

in their financial arrangements with related parties. The last section summarizes the main themes of this chapter.

3.2 Institutional and Regulatory Background in the East Asian Region

It is suggested that the economic institutions, legal system, ownership and corporate structure in East Asia allow RP transactions to occur. The information symmetry, lack of directors' integrity and independence as well as weak monitoring functions increase the likelihood of corrupt RP transactions (Claessens et al., 2000; Claessens, Fan, & Lang, 2002). This study argues that managerial and executive directors have many incentives to cheat their company's earnings, and utilize transactions with related parties. Since managers have the opportunity to select and apply accounting methods within the Generally Accepted Accounting Principles (GAAP), abusive RP transactions may occur without violating the legal and accounting framework. Improvements in the disclosure and implementation of more effective enforcement and monitoring procedures are needed to prevent misleading transactions with related parties. However, I find that institutional setting, governance, and legislative and regulatory approaches vary in East Asia. Most of the countries are ex-colonies of Britain, and while they refer to the same International Accounting Standards (IAS) and GAAP, they interpret 'related parties' and RP transactions differently. The following section discusses the institutional and regulatory background that is related to the growth of RP transactions. The discussion covers structure of equity capital, accounting framework and disclosures, requirements of stock exchanges, corporate governance and protection of minority shareholders.

3.2.1 Equity Capital Structure of Firms

Ownership structure is a key determinant of corporate governance (La Porta, Lopez-de-Silanes, & Shleifer, 1999; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Shleifer & Vishny, 1997). Most East Asian countries have highly concentrated ownership structures and the largest shareholders are in the form of a block or concentrated ownership format that constitutes the controlling shareholder (Gul et al., 2010; Hu et al., 2009). The controlling shareholder can be an individual, group of families, government or its agencies, or private entities, including foreign investors or firms. In this firm, control is enhanced through pyramid structures and cross-holdings among other corporate businesses. Voting rights, consequently, exceed formal cash-flow rights, especially among businesses in Indonesia, Japan and Singapore. Statistics show that more than two-thirds of firms in Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore and Thailand are controlled by a single shareholder (Claessens et al., 2000; Lins, 2003), and separation of management from ownership control is rare (Claessens et al., 2000; La Porta et al., 1999). Controlling shareholders also dominate 70% of Taiwanese publicly listed firms and there is a separation of control and cash flow rights (Wang & Pang, 2007). The domination or concentrated ownership structures of equity capital in many East Asia firms certainly create conducive landscapes for RP transactions to occur (Claessens et al., 2000).

OECD (2009) suggests that there are two broad control structures commonly used in the region, i.e. simple majority ownership and complicated network ownership. The easy majority ownership structure frequently involves controlling shareholders either as an individual, a group or family, corporations or state/federal government that takes the shape

of a holding firm. The consolidated ownership portion may convey effective control through a blocking minority (often 25% to 33%) or absolute control of more than 50%. The family or state is often represented at many senior management levels, and other executive directors are well connected to the family or state. The firms usually have a duality of chairman and CEO in a single position. While complicated network ownership structure is a nexus of shareholder agreements or interlinked boards grant effective control over the listed firm to a founding family. The controlling shareholders controlled firms via a pyramid of entities owned by them. This pyramidal structure is not uncommon for Asian firms, in which South Korean Chaebols are examples of this complex network ownership structure.

Most businesses in Malaysia and Thailand are family-controlled. Significant state control is the norm in Indonesia, South Korea, Malaysia and Singapore through the involvement of government-linked firms. Senior management of about 60% of firms listed in Indonesia, South Korea, Singapore and Thailand is related to the founder or family members of the controlling shareholder (Claessens et al., 2000). The controlling shareholders among a group of families also dominate about 58.2% of Taiwanese controlled firms (Wang & Pang, 2007). Although Thailand was never colonized by Britain, the Thai economy was integrated into the world economy in 1855, when the Bowring Treaty was signed between Britain and the former Siam. The treaty ended the Siamese King's monopoly power over international trade and foreign businesses started operating in Thailand. The revolution of 1932 led to an expansion of many family business groups that still dominate the economy of the country. The revolution also saw many Chinese immigrants becoming entrepreneurs in various industries (Bertrand et al., 2008). As a result, Wiwattanakantang (2001) noted that about

80% of non-financial firms traded on the Stock Exchange of Thailand are families controlled. The power to control a business might give a controlling shareholder use of corporate resources without good checks and balances (Chen, Firth, Gao, & Rui, 2006). The structure gives rise to RP transactions between family members and affiliated firms within the group. This kind of RP transaction would increase the risk to minority shareholders because the controlling shareholders can significantly expropriate wealth from them through family members.

The implication of controlling shareholders involve in managing firms would create an unbalance power for an authorization and governance mechanisms, making possible agency conflict Type II. The presence of controlling shareholder would most likely control the board and management, hence making the decision-making process to become unilateral. Thus, the firm business activities, including RP transactions are decided solely by the dominant controlling shareholders. They may also dominate the shareholder meetings through the number of votes cast, which insulates them from the corporate governance monitoring mechanism. The controlling shareholders can recruit, retrench and nominate directors who will serve at their behest. In the case of family-owned firms, the controlling shareholder often appoints family members to positions of non-executive directors, while in the state-owned firms the directors are political appointees or have links to the state. Therefore, the controlling shareholders have incentives to exploit corporate opportunities by abusing RP transactions. The possibility of extracting private benefit is the most severe challenge to the protection of minority shareholders (Wang & Pang, 2007).

In contrast, controlling shareholder structures could be efficient and potentially be beneficial to public shareholders. The controlling shareholders can make management more accountable, thereby reducing managerial self-serving practices. The controlling shareholder also could encourage better firm performance by pooling resources and information as well as reducing transaction costs (Thomas, Herrmann, & Inoue, 2004; Zhu, 2010). However, this depends on the trade-off between the benefits of monitoring managers and increased extraction of private benefit. Prior studies such as Dahya et al. (2008), Hu et al. (2009) and Chien and Hsu (2010) reveal a significant association between high concentrations of ownership and higher likelihood of RP transactions. The expropriation carried out by controlling shareholders is likely to be more severe in businesses where they are also managers and have more voting rights than cash flow rights, particularly in countries with poor legal protection and law enforcement practices (Bebchuk et al., 2000; La Porta et al., 1999).

3.2.2 Accounting Standards and Listing Requirements for RP Transactions Disclosure

Disclosure and reporting regulation is the most crucial measure to detect and discipline opportunistic and abusive behavior by controlling shareholders and senior managers. Transparency and consistency disclosure of RP transactions is essential so that prospective and existing shareholders can understand the rationale for, and nature of the transactions. Investors could assess the likelihood of conflicts and understand the potential effect of RP transactions. The obligation is to ensure that companies act in the best interests of investors so that RP transactions are executed at arm's length and on a commercial basis, and not compromise the wealth of shareholders. In East Asia, the development of rules and

regulation on RP transactions' disclosures is dissimilar due to different interpretations or definitions of related parties, RP transactions, and unclear thresholds in determining relatedness (OECD, 2009).

As stated earlier, most East Asian countries established their accounting standards regarding RP transactions based on International Financial Reporting Standards (IFRS) issued by International Accounting Standards Boards (IASB). The approved Financial Reporting Standards (FRS) such as FRS124-Related Party Transactions in Malaysia, TAS47-Related Party Disclosures in Thailand, and HKAS24-Related Party Disclosures in Hong Kong and FRS24-Related Party Disclosures in Singapore, provide guidance for disclosing RP transactions in financial reports. Instead of accounting standards, the RP transactions disclosures are also subjected to the stock exchange listing requirements in every country, and these vary. For example, publicly listed firms in Malaysia are required to fulfill the Bursa Malaysia Listing Requirements. The Stock Exchange of Hong Kong (SEHK) promulgates the disclosure and shareholder approval in the SEHK Listing Rules, while the Singapore Stock Exchange uses Chapter 9 of the Listing Rules which stated the General Mandate for RP transactions.

The thresholds of RP transactions are crucial points to determine the materiality of RP transactions that should be disclosed. Magnitude of RP transactions that is below the thresholds would be exempted from disclosure requirements. Furthermore, in determining whether an individual or an aggregate of transactions would be considered material, both the amount and the nature of the transaction must be considered. Certain transactions may not

be material in amount, but must be considered to be material in nature or otherwise and must be disclosed to investors. RP transactions that exceed a certain threshold must be disclosed, along with the terms and conditions of the transactions. These include the related parties involved, the relationship between them, description of the transactions, the transaction date, rationale and to what extent the connected parties or firms will benefit economically from the transaction. Specifically, FRS 124 in Malaysia requires a firm to disclose the nature of its RP transactions, which include at least, how many transactions, the amount of the outstanding balances, and the expenses recognized during the period in respect of bad or doubtful debts owed to the related parties. Firms are also required to disclose the relationships between themselves and related parties so that the financial statement users can assess the transaction. The transactions should be disclosed at least annually to shareholders in a timely fashion in the financial reports.

3.2.3 Legal Provision Relating to RP transactions

Most East Asian countries, including Malaysia, Hong Kong and Singapore, operate as common law systems, where there is a well-developed case law (legal framework) addressing conflict of interest transaction. Statutory provisions on substantial property transactions between related parties in many East Asian countries are based on UK precedents. The provisions are intended to prevent the transaction where there is potential for conflict of interest such as an acquisition of a firm's assets at an inflated price from, or disposal of the firm's assets at an undervalued price to directors or connected parties. Common law states there is a provision that identified a director as a key factor in relation to conflict of interest transaction. The provision requires the director to act and perform a duty

that maximizes the firm's best interests and must avoid any personal conflict of interest. Directors cannot misappropriate business assets, dispose of assets or acquire assets from it, and or receive any benefits in relation to their position as a company director.

As common law countries, Malaysia, Hong Kong of China and Singapore subscribe to the above common law position that directors have a duty to avoid conflict of interest and must act honestly. The Malaysian Companies Act 1965 also states a statutory provision that prohibits loans to directors or persons connected to directors, except in the case of an exempt private firm. The Malaysian Companies Acts 1965 also states specific provisions that mandate shareholders' approval must be obtained concerning directors' or related parties' transactions (disposal or acquisition of assets) if the magnitude of the transactions are substantial and reach a certain threshold. Section 132E (5) of the statute states that shareholders' approval is required when the value of the non-cash asset to be acquired from or disposed to its director, or a director of its holding firm, or to a person connected with the director exceeds two hundred and fifty thousand Ringgit or 10% of the firm's asset value. Additionally, section 132G deals with a firm acquiring the shares or assets from another firm in which a director or a substantial shareholder or a person connected with a director or substantial shareholders of the acquiring firm has influential share ownership in the target firm.

However, there is no specific statutory provision regulating the substantial property transactions (disposal or acquisition of firm's assets involving directors or related parties) in Singapore as stated in the Singapore Companies Act, or in the Hong Kong Firms Ordinance

and Indonesian Firm Law in Indonesia. In essence, section 160A-160D of the Singapore Companies Act is similar to section 132E of the Malaysian Companies Act 1965, but Singapore repealed its relevant section in 1998. The absence of the specific rule may point to a lack of shareholder protection. The statutory provision also does not address clearly conflict of interest between controlling shareholders and minority shareholders that may arise due to the existence of concentrated ownership. Shareholders, including minority ones must be provided with a protection mechanism to ensure the truthfulness of transactions entered into by the firm and related parties.

3.2.3.1 Amendment of Firm Law and Stock Exchange Listing Requirements

Many East Asian countries' company and securities laws or statutes are frequently amended to incorporate new developments that provide and enhance legal definitions related to internal dealing. Each country uses other jurisdictional means to reinforce legislation or amend it. In Hong Kong, the reform of the Firms Ordinance was an extensive public consultation process beginning in 2006, before it was recognized by the Legislative Council. Among the many changes recommended by the Firms Ordinance is enhanced accountability of directors, more shareholder engagement in the decision-making process and improved disclosure of business information.

Another recent example of legal reform are amendments to the Companies Act 1965 in Malaysia in 2007 and 2010 that clarified and better regulated RP transactions, strengthened shareholder rights, and a better definition of the board's role. Amendment of the Companies Act 1965 in 2007 banned loan transactions with related parties. Then, the amendment of

Bursa Malaysia Listing Requirements (BMLR) also allows the market participants to submit complaints to the regulator, Bursa Malaysia, which may contribute to effective enforcement through its proactive surveillance efforts.

In Singapore, the Ministry of Finance appointed a Steering Committee in 2007 to review the Companies Act to build on an efficient and transparent corporate regulatory framework. It is expected that the rules and principles will ensure transparency and strengthen accountability and lead to reduced regulative burdens on businesses. The Singapore Stock Exchange Listing Rules (SELR) also requires detailed disclosure of conflict of interest if issuers are unable to resolve conflicts prior to the listing. Approval mechanisms for RP transactions have been introduced throughout the region. In certain circumstances when RP transactions are considered “reasonable” prior approval is still required from the board and/or shareholders. In Singapore, rule 906 of the SELR requires shareholders’ approval to be obtained for an interested person transaction. The same provision is stated in the Securities Act of Thailand.

The Securities and Exchange Act in Thailand was amended in 2007 to provide stronger protection of investors’ interests, to enhance corporate governance of listed firms and to make key governance recommendations mandatory. The amended Thailand’s Securities and Exchange Act defines conflict of interest as including RP transactions that do not comply with the Security and Exchange Commission (SEC)’s requirements, the use of inside information and use of a firm’s assets or business opportunities. The amendment to the regulation concerning RP transactions contains approval by the board consisting of directors

and shareholders. However, this depends on type and size of the transaction and subsequent disclosure. Other East Asian countries such as Pakistan, Indonesia, Vietnam, and Taiwan also amended their securities or companies acts for the same purpose¹⁵.

3.2.4 Stock Exchange Listing Rules/Requirements

Stock exchange institutions in the East Asian region play important roles in governing and setting rules and regulations for RP transactions through listing requirements or rules. In governing RP transactions, the listing requirements emphasize their disclosure, threshold of the transaction and shareholders' approval. RP transactions that exceed a certain threshold should be disclosed and be subject to shareholder approval.

In Malaysia, Chapter 10, Part E of BMLR requires RP transactions¹⁶ to be disclosed to shareholders. The approved RP transactions together with its relevant information must be announced immediately to Bursa Malaysia. Firms that undertake RP transactions that are

¹⁵ An amendment to Pakistan's Securities and Exchange Ordinance in 2008 expanded the definition of insider trading as well as increased the applicable penalties. In Indonesia, BAPEPAM-LK issued a revision of Rules requiring extensive disclosure of RP transactions in 2008. The revised rule differentiates between affiliate transactions, where the firm must disclose to the regulator and make a public announcement within two days after such transactions occur. Any conflict of interest transactions must be approved by non-interested shareholders at the annual general meeting (AGM). Taiwan's Regulations Governing the Acquisition and Disposal of Assets by Public Firms (2007) as well as Vietnam's Enterprise (2005) and Securities (2007) Laws also contain provisions regarding the disclosure of RP transactions. The Firm Law in China requires the shareholders' meeting or AGM approval if a board member or senior management wants to engage in any transactions or contracts with the firm. The Vietnamese Code stipulates the approval of RP transactions by the AGM or the Board, but prohibits interested parties from participating in the process of approving such transactions. In Pakistan, amendments to the Code of Corporate Governance have made the Board of Directors responsible for the assessment of RP transactions, whether a price is determined on an arm's length basis and obtained shareholders' approval. Under the Commercial Act 2009, South Korea goes one step further where minority shareholders can hold the board member involved in abusive RP transactions accountable and seek to protect the firm's assets through legal actions.

¹⁶ The Bursa Malaysia Listing Requirements define a related-party transaction as a transaction entered into by the issuer or its subsidiaries that involve the interest, direct or indirect, of a related party. The transactions for the purposes of RPT include the acquisition, disposal or leasing of assets, the establishment of joint ventures, the provision of financial assistance (lending or advancing any money or guarantee, indemnity or provide collateral for a debt), the provision or receipt of services, or any business transaction or arrangement entered into by a listed issuer or its subsidiaries.

more than 5% of net tangible assets are required to send a circular with relevant information to their shareholders. Chapter 10, Part E of the BMLR also requires a publicly listed firm to obtain a prior mandate approval of its shareholders for all RP transactions at an Extraordinary General Meeting. In relation to the abstention of voting by interested parties, the BMLR (Chapter 10) states that in a meeting to obtain shareholders' approval, the related parties (interested director, major shareholders or person connected with directors or major shareholder with any interest, direct or indirect) must not vote in approving the resolution of the transaction. A director or major shareholder must ensure that the persons connected with him/her abstain from approving the resolution of the transaction. Chapter 10 of BMLR also requires the publicly listed firms to seek annual renewal of shareholders' approval for recurrent RP transactions, which are necessary for day-to-day operations.

During the shareholders' meeting, firms should appoint an independent advisor to comment on whether the transaction is fair and reasonable. Shareholders, particularly the minority shareholders are advised on whether they should vote in favor of the transactions. The shareholders could request independent directors to give their opinion about the transaction. Directors who have been identified as having a conflict of interest in the transaction would abstain from making a recommendation to shareholders. In the event of the transaction involving more than 25% of the net tangible asset, companies should also appoint the principal advisers as well as an independent adviser.

Similar to Chapter 10 BMLR, Singapore Stock Exchange (SSE) states a listing requirement of RP transactions under the SELR. Chapter 9 of the Singapore Exchange Listing Manual

(SELM) requires public firms to disclose and obtain shareholders' approval for an interested-person transaction. Recurrent RP Transactions are also mentioned in the SELR, section 920(1), where shareholders' approval is required for recurrent RP transactions that are necessary for its day-to-day operations, but not in respect of the purchase or sale of assets, undertaking or businesses. However, SELR requires strictly lower thresholds compared to BMLR, where any transaction greater than 3% of net tangible asset must be disclosed to the market. Listing Rules 906 requires any transaction at 5% or more of net tangible asset to be approved by shareholders.

The Hong Kong Stock Exchange Listing Requirement (HKSELR) demands that shareholders' approval must be obtained, with the interested person abstaining from voting on a transaction at the general meeting. Rule 14A.16 of HKSELR classifies a RP transaction's threshold for disclosure and approval into several categories¹⁷. The first category refers to RP transactions that are exempted from the reporting, announcement and independent shareholders' approval requirements. The second category refers to RP transactions that are exempted from the independent shareholders' approval but are required to fulfill the reporting and announcement requirements. The next two categories focus on continuing or recurring RP transactions. They are categorized as continuing connected transactions which are exempted from the reporting, announcement and independent shareholders' approval requirement, and recurring connected transactions which are exempted from the independent shareholders' approval requirements. The last category refers to any RP transactions not falling into any of the above categories.

¹⁷ Hong Kong Stock Exchange Listing Requirements use the term "connected transactions" which is defined as any transaction between a listed issuer or any of its subsidiaries and a connected person.

The HKSELR clearly distinguishes the requirement's features based on the materiality threshold of the transactions. Certain connected transactions are exempted from the disclosure obligation and shareholders' approval, while some transactions are only subjected to the disclosure's requirement. When there is no shareholders' approval required, the HKSELR states under rule 14A.55, that board minutes approving the connected transaction are to be given to the Exchange, where the minutes must clearly reflect the views of the independent non-executive directors, and whether the directors have any material interest and be abstained from voting on the transactions.

In Thailand, the Stock Exchange of Thailand Listing Regulations (SETLR), Clause 9 provides specific rules for connected transactions, which defines RP transactions as transactions between listed firms or a subsidiary firm and the listed firm's connected persons. Rule 3 of the regulations states that RP transactions include any contract or agreement, whether direct or indirect, leading to the acquisition or disposition of assets and/or rights to acquire or dispose of assets. It also includes leasing or renting assets, an offer or a receipt of service, an offer or receipt of financial assistance and an issuance of new securities, and an arrangement to create rights or waiver of such right to do the same. Similar to the HKSELR, some RP transactions in Thailand may not require the board's or shareholders' approval, although there is always a disclosure obligation that must be made to the Stock Exchange. It depends on the magnitude value of the RP transactions. The SETLR only requires a company's board of directors to approve RP transactions, while shareholder's approval is required where at least three-quarters voted in favor of the transaction. In this

case, a listed firm or its subsidiaries that enter RP transactions must ensure that the firm seeks approval from the board of directors where the interested directors are precluded from attending the meeting and voting at it. As another example, BAPEPAM¹⁸ Rule IX.E.1 indicates that RP transactions are treated differently.

3.2.5 Protection of Minority Shareholders' Interests

Currently, there are provisions requiring disclosure and access to information allowing minority investors to monitor the activities of firms and preserve a firm value. A particular concern for minority investors is the use of corporate assets by firm insiders for personal gain, of which RP transactions are the most common example. If the laws and regulations do not provide such protection against this practice, minority investors may be reluctant to invest. A decade ago, the majority of East Asian countries were considered to have weak protection mechanisms for minority shareholders (Claessens et al., 2000; La Porta et al., 1999; Wang & Pang, 2007). However, after the Asian financial crisis, several regulations have been implemented. In some countries, governments and regulators have established a central minority shareholders' group or investor associations such as the Minorities Shareholders Watchdog Group (MSWG) in Malaysia, Singapore's Securities Investors Association (SSIA) in Singapore, and Thai Investors Association (TIA) in Thailand.

¹⁸ BAPEPAM stands for Badan Pengawas Pasar Modal (Capital Market Supervisory Body) which was established under the Capital Market Law 1995. Rule IX.E.1 of BAPEPAM requires transactions that have conflict of interest involving related parties, including a commissioner, director and substantial shareholders must be approved by independent shareholders. This approval must be confirmed in the form of a notarized deed at a meeting attended by independent shareholders representing more than 50% of the shares owned by the independent shareholders. If the quorum does not occur, a second meeting may be held with the same quorum and voting requirement. Again, a third meeting may be held with the approval of BAPEPAM if the meeting's quorum does not proceed. At this meeting, no quorum is specified but the voting requirement to approve the RP transactions requires than 50% of independent shareholders to attend.

These investors associations allow for some consultations to help protect minority shareholders. Minority shareholders may feel aggrieved over a certain action undertaken by the firm, thus the investor associations can co-ordinate a possible solution and consult minority shareholders. Investor associations may also allow coordination of expenses when legal action is required. Without such bodies, minority shareholders may struggle to make use of their rights in a cost-effective and coordinated manner. MSWG, for example, has taken on a more active role in shareholder meetings and produces an index of corporate governance practices that businesses employ. MSWG and TIA also send qualified volunteers to attend all listed firms' annual general meetings and encourage shareholders to ask pertinent questions and vote. MSWG also conducts education programs, which are targeted to the general public, particularly retail investors so that they are aware of their rights as shareholders and be better informed. Further, they publish articles and commentaries in popular newspapers and online. However, the effectiveness of this body in protecting the minority shareholders from RP transactions has to date not yet been explored.

3.2.6 Corporate Governance Reforms in the East Asian Region

Weak corporate governance has frequently been cited as one of the causes of the East Asian financial crisis of 1997-98, where firm-level differences in practicing corporate governance had a strong detrimental impact (Mitton, 2002). The financial crisis exposed many institutional and policy weaknesses, including the structure, implementation and enforcement of corporate governance control mechanisms in the region. The presence of controlling shareholders in the majority of firms may also reflect the poor governance and the legal protection levels for outside investors (La Porta et al., 1999; Wang & Pang, 2007).

The weaknesses of corporate governance caused the control system being used to expropriate wealth of stakeholders. The poor investor's protection would increase investment risk for the investors and shareholders. Prior studies support the importance of investor protection, mainly for minority shareholders with reference to corporate governance (Johnson et al., 2000; La Porta et al., 2000).

There is evidence that during the financial crisis, countries with effective minority shareholder protection were less affected, while countries with weak enforceable minority shareholders rights suffered the most (Johnson et al., 2000). Without strong shareholder protection, senior management, executive directors and controlling shareholders may utilize the opportunities to expropriate businesses' wealth, specifically through transactions with related parties and leads to a further outflow. Prior research also associates RP transactions with a poor corporate governance mechanism system where poorer governance makes these transactions more likely to occur (Kohlbeck & Mayhew, 2004; Villalonga & Amit, 2006). Therefore, the protection of minority shareholders' rights is critical, particularly in Asia as a result of the concentrated ownership by controlling shareholders in most firms. Certain enhancements have been taken to reinforce shareholder rights by increased availability of legal redress mechanisms, a greater focus on combating abusive RP transactions, and the emergence of shareholder engagement. The reforms should include requirements that all listed firms in East Asian countries disclose RP transactions and introduce approval mechanisms by shareholders and/or the board of directors. A country with weak minority shareholder protection needs to reform its corporate governance structures or mechanisms (La Porta et al., 2000).

3.2.6.1 Corporate Governance Best Practices Code

The corporate governance reforms in East Asia were initiated by the Organization for Economic Co-operation and Development (OECD)¹⁹ with the cooperation of the Asian Roundtable on Corporate Governance (ARCG)²⁰. This co-operation serves as a regional hub for exchanging experiences and advancing the corporate governance reform agenda in Asia. Since then, every country in the East Asia region has national corporate governance codes, and many have institutions promoting good corporate governance by adopting the best-practice principles recommended in the White Paper 2003²¹. The best-practice principles would enhance the effectiveness of the corporate governance control mechanisms in protecting the interests of minority shareholders. A wide range of laws and regulations have been enacted; financial reporting standards are developed, and an enforcement perspective is strengthened. A corporate governance infrastructure has been implemented; something that did not exist before the 1997 financial crisis.

¹⁹ OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalization. The OECD is at the forefront of efforts to understand and to help the governments and regulators respond to new developments and concerns in enhancing corporate monitoring mechanisms. The OECD Principles of Corporate Governance in 1999 became a benchmark for policy makers, investors, corporations and other stakeholders worldwide. The OECD's principles were used by an Asian Roundtable on Corporate Governance (ARCG) as the basis of the White Paper on Corporate Governance in Asia, 2003.

²⁰ The ARCG was established in 1999 by the Asia-Pacific countries, and the OECD drove improvements in corporate governance rules and practices. The Asian financial crisis in 1997 exposed many institutional and policy weaknesses, encouraging ARCG serves as a high-level regional forum for a structured policy dialogue on corporate governance. It also provides participants with direct access to the work of the OECD and the developments in other parts around the world. The ARCG countries include Bangladesh, China, Hong Kong, India, Indonesia, South Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan, Thailand and Vietnam. The OECD works with the ARCG to strengthen the best practices of corporate governance. The ARCG issued the White Paper on Corporate Governance in Asia in 2003 with OECD Principles of Corporate Governance to improve corporate governance in the region. The ARCG also established a Task Force on RP Transactions in May 2008 with the aim of developing a guideline for RP transactions. This guideline was issued by the OECD in 2009 to help policy makers, enforcement authorities, private institutions, shareholders and other stakeholders with options for monitoring and curbing corrupt RP transactions, focusing on disclosure and the board/shareholders system in the Asia-Pacific region.

²¹ The White Paper 2003 contains a set of common policy, objectives and a number of concrete recommendations on how to improve governance control mechanisms. The recommendations may vary between countries, since the White paper recognizes the Asia-Pacific as a diverse region in terms of legal traditions, regulatory infrastructure, and economic development.

Before the Asian financial crisis, only Hong Kong of China East Asia had a corporate governance code, the 1993 Voluntary Code of Best Practice. The Securities Commission of Malaysia established the Malaysian Institute of Corporate Governance (MICG) in 1999 to produce a Malaysian Code on Corporate Governance in 2000. Indonesia and Singapore issued the codes in 2001 and were followed by China, Taiwan, Pakistan and Thailand in 2002, and the Philippines in 2003. The recommendations of the White Paper's principles led to a revision of the existing codes as well as introducing new best practices of corporate governance for countries that had yet to develop the code. Amending the codes in various countries strengthened the corporate governance system and prevented corrupt financial management by board members, controlling shareholders and other related parties (Abdul-Wahab et al., 2011; Ge et al., 2010). In 2009, the Philippines also revised its Corporate Governance Code to elaborate on the specific duties and responsibilities of board members. Nevertheless, the establishment of the best practices code was not legally enforced, which makes it doubly important to review and revise the relevant legislation so that it is effective.

3.3 Review of Determinants of RP Transactions

The number and volume of RP transactions have been increasing in East Asia, particularly in China's listed firms. This study believes that a business environment (landscape) in East Asia such as the structure of corporate governance, the rule and regulation regime, investor protection and enforcement, and equity capital structure may influence the growth of such transactions. The development raises concerns of certain stakeholders because opportunistic company directors, managers or controlling shareholders can use RP transactions to commit

fraud or mismanage company earnings (Henry et al., 2007). This section discusses the determinants of RP transactions.

3.3.1 Protection of Shareholders' Interest

A decade ago, East Asian countries were well renowned for poor investor protection, where the systems and structures of controls and governance led to expropriated wealth from shareholders (Claessens et al., 2000). A legislative and regulatory approach in monitoring and curbing abusive RP transactions varied throughout Asia due to the lack of implementation and enforcement by the authorities and other relevant regulators. The growth in number and volume of RP transactions occurred in countries with weak protection of stakeholders' interests, particularly for dispersed and minority shareholders. Martin de Holan and Sanz (2006) and Dahya et al. (2008) show evidence that controlling shareholders are so inclined to expropriate wealth of other shareholders via RP transactions in countries with weak legal mechanisms. Deng, Gan, and He (2006) also note RP transactions are linked to weak property rights protection. Controlling shareholders easily utilize RP transactions to expropriate resources and wealth at the expense of minority shareholders or otherwise implement a dividend policy that allows them to retain as much corporate resources by them.

The institutional ownership failure in providing protection to the shareholders, particularly minority ones contributed to the growth in number and volume of RP transactions in East Asian economies (Jian & Wong, 2010; Wang & Pang, 2007). Wang and Pang (2007) provide such examples like Lawn Taiwan where it was stated that a rule on certain crucial

issues must be passed at the shareholder meeting, but in practice, the shareholder meeting failed to protect shareholders' interests. This failure was caused by shareholders not raising proposals at their meeting, and participation was restricted to vote 'yes' or 'no' to the proposed proposals by the board of directors. Gao and Kling (2008) provide further evidence that institutional ownership does not prevent the misappropriation of assets. They argue that institutional ownership alone does not foster internal governance mechanisms that can reduce operational tunneling. Zhu (2010) provides supportive evidence regarding China's securities market failure to punish and prohibit illegal insider trading effectively. These situations strengthen the argument that countries that cannot protect shareholders' interests will not prevent managers or controlling shareholders from manipulating RP transactions for their own benefit.

It is essential to ensure that the implemented regulations are efficient and well enforced. Without strong enforcement by the regulators, the regulations will be unable to protect the interests of shareholders effectively. Some studies suggest that an improvement is needed to increase protection of shareholders through amendment of certain laws and regulations. Aharony et al. (2010) stress this can be done by minimizing investment risks faced by foreign investors in China's capital markets. They find evidence that in underdeveloped markets, RP sales and purchases are not likely to be an efficient business choice able to minimize transaction costs for firms. Rather, the evidence shows that RP sales, in particular, could be used opportunistically to manage earnings upwards in the pre-IPO period.

Atanasov et al. (2010) indicate that in Bulgaria investors reconsider the tunneling risk and re-update their valuation when the Bulgarian Securities Law was changed in 2002. The legal changes limit both dilution of equity offering and freeze outs forced sale of minority shares to the controller for below-market price. They expect that the new provision would restrict equity tunneling by the related parties. The evidence shows that the adoption and implementation of certain legal changes in Bulgaria successfully bound equity tunneling through dilutive equity offerings and freeze outs. This finding highlights the importance of legal rules enhancing the protection of shareholder's from abusive transactions between related parties as well as increasing investors' confidence in avoiding the tunneling risk. However, Berkman et al. (2009) emphasize firms that experienced massive RP transactions usually have weak monitoring control mechanisms and strong ties to government or political connections. In this context, politically related parties may use the firms' resources to retain their influence, and it is very difficult for regulators to enforce the new rules on firms where block holders have a strong connection with political parties that are in power.

Separating voting and cash flow rights could diminish protection of shareholders, particularly minority shareholders. Controlling shareholders can use their dominant voting and cash flow rights to expropriate wealth from minority shareholders. Studies suggest that these firms do not implement control mechanisms by separating voting and cash flow rights. For example, Wiwattanakantang (2001) reveals that controlling shareholders do not extract private benefit since these firms do not implement control mechanisms. Lin et al. (2010) contend that the ratio of cash flow to control rights of the controlling shareholders and board's affiliation with institutional owners could play an important role in minimizing the

negative impact of those RP transactions where concentrated ownership is concerned. However, it is not easy to improve protection of minority stakeholders.

3.3.2 RP Transactions Disclosure and Regulations

It has been argued that a lack of transparency arising from inadequate disclosure creates significant problems for investor decision-making, which contributes to erosion of their confidence. They will not be able to determine a corporation's stability and wealth, resulting in investors, especially foreign and minority investors being reluctant to hold shares for fear of an imminent loss. Mitton (2002) comments that firms offering higher disclosure quality and greater transparency, a more favorable ownership structure, and a more focused organization, provided better protections for their minority shareholders during the 1997 financial crisis. The comment emphasizes the need for more effective corporate governance through better disclosure²².

Transparency and consistency of disclosure will allow shareholders to better understand the rationale of RP transactions. Kohlbeck and Mayhew (2010) emphasize that such disclosure of RP transactions provides the market with the information necessary for investors to punish opportunistic behavior. The given information must include a magnitude and nature of the transaction and approval of shareholders. However, investors cannot directly prevent dishonest RP transactions. Investors have only a limited capacity to sell or buy stock of firms engaged in RP transactions, or otherwise execute ex-post litigation against

²² Most of the Asia-Pacific countries established laws and regulations on RP transactions by adopting and practicing International Financial Reporting Standards (IFRS) issued by International Accounting Standards Board. Approved Financial Reporting Standards (FRS) such as FRS124-RPTs in Malaysia, TAS47-Related Party Disclosures in Thailand, and HKAS24-Related Party Disclosures in Hong Kong and FRS24-Related Party Disclosures in Singapore, guide the disclosure of RP transactions in financial statements. Various stock exchanges also introduced listing requirements to monitor the transparency of RP transactions by listed firms.

opportunistic insiders. Based on the RP transaction disclosure, Kohlbeck and Mayhew (2010) find that investors value the firms disclosing RP transactions critically. No-one yet knows how much information will be provided by businesses and it may be that much irrelevant information will obscure that which is important, and new regulations as well as financial reporting standards will not prevent fraud. Similarly, based on RP transaction disclosures, Ge et al. (2010) conclude that RP sales and RP services are negatively associated with firm market valuation.

3.3.3 Corporate Governance Structures

A principal-agency conflict is an essential one in a corporate governance system. Corporate governance serves as an effective mechanism to constrain controlling shareholders or managers to opportunistically use RP transactions to manipulate financial statements in their favor (Chung, Firth, & Kim, 2002; Yeh et al., 2012). An effective corporate governance structure becomes a major determinant of the firms involved in RP transactions (Chien & Hsu, 2010; Gordon et al., 2004; Lo et al., 2010a) where, the growth in RP transactions is often associated with weak governance systems. It raises concerns that opportunists are able to utilize governance control weaknesses for their own benefit. Gordon et al. (2004) and Berkman et al. (2009) empirically demonstrate that weaker corporate governance mechanisms have been associated with large RP transactions. The results suggest that RP transactions are in effect conflicts of interest between managers/board members and shareholders.

In contrast, good corporate governance can reduce managers or controlling shareholders' opportunistic behaviors in using RP transactions for personal gain, and thus reduce monitoring costs associated with financial manipulation (Lo et al., 2010a). Chien and Hsu (2010) find that effective corporate governance mechanisms like board independence, and supervisors could transform RP transactions into efficient and legal transactions. Gao and Kling (2008) state that tunneling activity through RP transactions declined during 2001 due to better governance structures for public firms in China. A recent study, Yeh et al. (2012) also shows that propping-up activities are less likely to occur when the governance structure is strong.

3.3.3.1 CEO Duality

CEO duality is a corporate governance practice where one person is both a company board's chairman and chief executive officer (CEO). This situation has been known to increase the risk of RP transactions. Jensen (1993) suggests that the board will not monitor senior management when the CEO is also the chairman of the board. In support of this view, Chen et al. (2006) find firms that commit fraud are more likely to have CEOs who are board's chairmen. If the controlling shareholders appoint the board chairman as the CEO, the controlling shareholders wield power over the management, which will cause a breakdown in the checks and balances of corporate governance. The failure of this internal decision control system will give controlling shareholders a free hand to engage in RP transactions, and thus increase the size of the RP transactions, which are corrupt in character.

This argument is supported by Hu et al. (2009) who reveal when the same person is both board chairman and CEO, the size of RP transactions increases significantly. In addition, based on a unique sample of 266 firms listed on China's stock exchange, Lo et al. (2010a) examine whether the CEO/chair duality will increase transfer pricing manipulation. They find that a different person occupying the chair and CEO positions are associated with less likelihood of manipulating earnings for transfer pricing. Furthermore, Efendi, Srivastava, and Swanson (2007) investigate the incentives that led to the rash of restated financial statements at the end of the 1990s market bubble. They find that the likelihood of a misstated financial statement becomes prevalent when the CEO serves as board chairman. This finding suggests that CEO duality will reduce the balance of power in corporate governance and make a RP transaction with related parties (mainly with the CEO) easier to carry out.

3.3.3.2 Political Connections

Recent studies document that firms undertake transactions with related parties who are politicians. Since they have ties with senior executives or large shareholders, agency problems are likely to be more severe and common for politically connected firms. Political connections are usually relationship-based rather than expressions of market-based capitalism (Adhikari et al., 2006; You & Du, 2012). They tend to use their political resources for their own good like retaining power and influence. CEOs who have political connections are more likely to appoint bureaucrats to the board of directors rather than directors who do have relevant professional backgrounds (Fan, Wong, & Zhang, 2007). Shleifer and Vishny (1994) and Hellman, Jones, and Kaufmann (2003) suggest that

politicians' intervention in business activities is more severe when institutional constraints are weak. Acemoglu and Johnson (2005) provide cross-country evidence where countries with weaker property rights and limited protection against expropriation by politicians have substantial lower per capita income and investment rates, and less-developed stock markets. Leuz and Oberholzer-Gee (2006) suggest that politically linked firms have difficulty in re-establishing connections with a new government when their patron falls from power. They also suggest that the minority shareholders in this politically linked firm are usually exposed to wealth expropriation.

Leuz and Oberholzer-Gee (2006) have empirical evidence that firms with politically connected CEOs underperform compared to those firms without politically connected CEOs. They examine the role of political connections in firms' financing strategies and their long-term performance using data from Indonesia. They find that firms with strong political connections are less likely to have publicly traded foreign securities and resulting estimates of business performance using foreign finance are severely biased, leading to businesses not performing well. Fan et al. (2007) examine CEOs in a sample of 790 newly partially privatized firms in China run by former or current government bureaucrats. Firms with politically connected CEOs perform worse than those without politically connected CEOs by almost 18% based on three-year post-IPO stock returns, and have poorer three-year post-IPO sales and earnings growth.

Boubakri, Cosset, and Saffar (2008) investigate the extent of political connections in newly privatized firms using a sample of 245 privatized firms headquartered in 27 developing and

14 developed countries over the period 1980 to 2002. They find that politically-connected firms have poor accounting practices compared to their non-connected counterparts. A recent study, Chaney, Faccio, and Parsley (2011) investigated whether earnings quality varies systematically with political connections in a large sample of 19 countries. They use data for over 4500 firms and document that the quality of earnings reported by politically connected firms is significantly poorer than that of similar non-connected firms. The results suggest that the firms linked to politicians may intentionally disclose poor quality information in an attempt to mislead investors so that insiders can gain at their expense. It may also be that once political connections are established; businesses enjoy the protection and do not need to respond to market pressures to improve the quality of information. Thus, connected firms can afford to disclose poor quality accounting information through managing discretionary accruals. Peng et al. (2011) show that political connection is negatively associated with firm performance due to tunneling or propping activities. They also find no significant differences between central and local government controlled firms related to the RP transactions. The above evidence shows that minority shareholders suffer from firms having political connections. Berkman et al. (2011) also remind us that investors who are minority shareholders could not expect regulators to enforce the new rules on firms where block-holders have strong political connections.

3.3.4 Economic and Financial Determinants

3.3.4.1 Achieving Objectives

Business opportunists may use RP transactions to achieve objectives such as buying or selling shares, initial public offerings (IPOs) or to obtain compensation in their role as

directors. Sawicki and Shrestha (2008) analyze the relationship between insider trading and discretionary accruals that measure earnings management. They find strong evidence that insiders manage earnings downward when buying and managing earnings upward when selling. For further evidence, Cheung et al. (2009) find that publicly listed firms enter deals with connected parties to obtain favorable prices compared to similar arms-length deals. Borkowski (2010) documents that certain related parties used multinational corporations to facilitate income shifting and obfuscation of financial data using improper transfer pricing to avoid tax. Chen et al. (2011) and Aharony et al. (2010) investigate the impact of controlling shareholders with RP transactions on IPO operating performance. They reveal that RP sales of goods and services are employed opportunistically to manage earnings upwards or downward in the pre-IPO and post-IPO period. The evidence suggests that controlling shareholders may structure RP transactions to boost sales and/or profits.

3.3.4.2 CEOs' and Directors' Compensation

An executive compensation scheme may serve as a bond by which senior executives act in the best interests of shareholders (Chung & Pruitt, 1996). Firms that engage in RP transactions can provide minimum cash compensations that benefit officers and directors, or firms may use them to increase compensation to officers and directors. Alternatively, relatively low cash compensation levels can motivate managers and directors to use RP transactions to supplement their cash compensation (Kohlbeck & Mayhew, 2004). Kohlbeck and Mayhew (2004) argue RP transactions can result from or be managed via contracting. They investigate links between RP transactions and compensation-based incentives, and links to executive compensation. They use a sample of 1261 firms and find

RP transactions are inversely associated with CEO stock options and cash compensation. They also find a positive association between unexpected CEO compensation and RP transactions which business partially own through investments, suggesting that CEOs are compensated for running more complex organizations. Hu et al. (2009) find evidence that large compensation schemes for outside directors are associated with more RP transactions.

3.3.4.3 Alternatives to Financial Distress

Economic and financial conditions could influence firms to resort to RP transactions, specifically when there are firms within the group of firms facing financial difficulties. This is consistent with the view that RP transactions represent efficient transactions. The financially distressed firms are able to get funding support from the group's members or affiliates (Gopalan, Nanda, & Seru, 2007); however, it can also represent the potential for tunneling or propping up. Guo and Ma (2009) investigate tunneling and propping up in Chinese's businesses and their related parties, finding that firms experiencing financial distress engage in more tunneling or propping through RP lending to or from controlling shareholders. Gallery et al. (2008) indicate that the state of finances dominates a firms' decision to engage in RP transactions.

Since most research shows that RP transactions support conflict of interest, Gopalan et al. (2007) suggest RP transactions between group firms and their subsidiaries, associates or affiliates are efficient transactions during a financial crisis. They investigate the functioning of internal capital markets in Indian business groups and find that intra-group loans are beneficial means of transferring cash across group-affiliates firms, which are typically used

to support financially weaker firms. Strengthening affiliated firms with the goal of overcoming constraints appears as a primary motivation to access the internal capital market within the business group firms.

3.3.5 External Monitoring of RP transactions

Corrupt RP transactions often involve senior management and executive directors (Henry et al., 2007) showing a weak internal governance mechanism (Abdul-Wahab et al., 2011; Gordon et al., 2004). Minority shareholders cannot fully rely on an internal monitoring mechanism. An external monitoring mechanism such as auditors and independent non-executive directors are considered the best for controlling senior management because they can do their work independently (Gallery et al., 2008).

3.3.5.1 Board and Audit Committee Independence and Expertise

Board independence is an essential ingredient for effective monitoring. Fama and Jensen (1983) argue that the presence of independent non-executive directors implies the presence of deciders who have no economic interest in the firm, and who do not take any part in its operations. Independent non-executive directors are appointed to the board, mainly to provide unbiased monitoring of the board's decision-making process. Thus, effective board independence can reduce agency conflict and improve performance. The independent directors can also perform their independent monitoring roles through an audit committee. Abbott, Parker, and Peters (2004) support the view that independence and the audit committee's level of activity are important elements in creating reliable financial reports. Their study finds that independent audit committees do have a significant and negative

association regarding financial reporting restatements. Thus, independent non-executive directors through their position on the board of directors and/or audit committee can monitor RP transactions, reduce tunneling behavior, and improve firm performance.

Lo et al. (2010a) find that firms with a high percentage of independent directors, who are representatives of the parent firms, are associated with less manipulation of transfer pricing. The mere establishment of an audit committee among independent directors also results in the largest shareholders not having a significant impact on price manipulations via RP sales transactions. Their findings are consistent with RP transactions reducing a firm's value, but the presence of the independent directors reduces the likelihood of RP transactions, and improves a business's value. Directors' appointment to audit committee membership with financial expertise is also related to less manipulation of transfer pricing.

Dahya et al. (2008) analyze the roles of independent directors in curbing RP transactions between dominant shareholders and controlled entities. They find a significant negative relationship between board's independence and the likelihood of RP transactions, and the relationship between Tobin's Q and occurrence of RP transactions. It is suggested that a higher proportion of independent directors, particularly financial experts, are linked to less likelihood of RP transactions. In fact, the firm's value is also positively related to the proportion of independent directors comprising the board. Nevertheless, if the related parties are controlling shareholders with voting rights or family members from these controlling entities, it is relatively difficult for the board and audit committee to be effectively independent.

3.3.5.2 Audit Quality (Audit Firm Size and Length Tenure Auditor-client Relationship)

The main role of the auditor is to enhance the credibility of the firm's financial statements by expressing an independent opinion on their reliability and fair presentation of the financial results (Kleinman & Palmon, 2001). Thus, the auditor's independent judgement or opinion is the cornerstone of the audit profession and an essential ingredient of users' confidence in financial statements. Since independent auditors occupy a position of trust between the management of the reporting entity and users of its financial statements, they must be perceived to be operating independently, use proper auditing standards and have strong ethical principles (Goldman & Benzion, 1974; Mautz & Sharaf, 1961).

Several studies have examined the role of the auditor in monitoring corrupt RP transactions or expropriation activities, particularly by the largest or controlling shareholders. Gallery et al. (2008) investigate the associations between RP transactions in small, newly listed Australian firms, governance and their performance factors. They find weak evidence that internal corporate governance constrains the amounts of payments and loans to related parties. These initial findings are also consistent with the view suggesting that RP transactions do not serve shareholders' best interests. However, external monitoring is a more effective control over RP transactions than internal governance mechanisms. Chien and Hsu (2010) investigate the moderating effect of corporate governance on the negative relationship between RP transactions and firm performance. They use Big-4 CPA firms or independent boards and supervisors to represent governance mechanisms, and suggest that the effect of RP transactions on firm performance is conditional on the governance

mechanisms system. The empirical results suggest that corporate governance mechanisms change RP transactions from conflicts of interest to efficient transactions. The findings conclude that Big-4 CPA firms or independent boards and supervisors can play moderating roles in RP transactions.

However, since Arthur Andersen & Co.'s involvement in the Enron accounting scandal, the ability of the auditor to protect shareholders' interests has been subjected to criticism (Goodwin, 2002; Kleinman & Palmon, 2001). An auditor's failure to recognize or disclose RP transactions has been identified as the ninth most common audit deficiency (Beasley et al., 2000). There are two views that could explain the audit deficiency either the auditor is unaware of RP transactions or the auditor may choose to cooperate with the client's decision to conceal them (Beasley et al., 2001). This view is supported by Gordon et al. (2007) who suggest those firms that chose to utilize RP transactions in manipulating their financial reports are likely to appoint auditors with whom do they have a relationship. Thus, it raises concerns that non-independent auditors can attest to financial reports being misleading due to RP transactions.

The above prior studies show that the presence of auditors as an external monitoring mechanism is effective in preventing corrupt RP transactions. An audit quality that is usually measured by the audit firm size or audit opinion can reverse the negative impact of RP transactions. Nevertheless, the above argument contradicts that of Gordon et al. (2007)²³ who conclude that firms involved in financial reporting manipulation through RP

²³ Gordon et al. (2007) suggest those firms utilizing RP transactions to manipulate their financial reports are likely to choose auditors with whom they have a relationship.

transactions favor appointing auditors with whom they have a close relationship. I argue that a big or non-big audit firm cannot represent the close relationship as suggested by Gordon et al. (2007). I believe that the close relationship can grow through longer tenure of audit engagement. As a result, the auditor may become complacent and not rigorous enough in querying the clients, senior management or controlling shareholders regarding RP transactions. Nevertheless, the effect of an auditor-client relationship in mitigating abusive RP transactions, as well as their effect on earnings quality, has not been fully explored and requires future research.

3.4 Summary and Conclusion

This chapter discussed the background and institutional settings in East Asia regarding the regulation (or lack of it) of RP transactions. The discussion highlighted the structure of equity capital, the weaknesses of corporate governance control mechanisms and the lack of shareholder protection that have existed in Asia since the region's 1997 financial crisis. The chapter then outlined corporate governance reforms and amendments to regulatory framework, in various East Asian countries initiated by the OECD-ARCG. The reforms include revising the best practice codes and stock exchange listing requirements, and improving company law. The rationale is to protect shareholders or investors to effectively rebuild their confidence. Amendments and reforms may change the attitude of the managers or controlling shareholders in executing RP transactions and remove investors' poor opinions of RP transactions. However, this depends on the success of the implementation of recommended best practices and regulations. The major significant obstacles in applying them are difficulties of monitoring and obtaining proof of RP transactions. The complexity

of such transactions makes it difficult to prove offences beyond a reasonable doubt. These four East Asia countries, namely Hong Kong of China, Malaysia, Singapore, and Thailand are considered advance in the corporate governance reforms and the amendment of rules and regulations. These countries now offer strict protections for minority investors, where they regulate an approval of RP transactions, a high level of disclosure, clear duties for directors and easy access to corporate information.

This chapter also reviewed a body of research on what motivates firm dealings with related parties. Businesses, managers or controlling shareholder involvement in RP transactions is influenced by several variables, such as structure of equity capital and corporate governance control mechanism. Specifically, a weak corporate governance structure, concentration of equity capital structure, lack protection of shareholders' interests and lack of enforcing of rules and regulations are the major issues. The presence of independent non-executive directors and external auditors is also effective in targeting and highlighting opportunistic RP transactions.

In an overall, this chapter emphasizes determinant of firms to engage in RP transactions and understand the likelihood of such transaction may be used opportunistically to realize manager's conflict of interest. Nevertheless, this study seeks evidence about consequences of firm's (managers and controlling shareholders) engagement in RP transactions. Thus, this study does not develop hypotheses for these determinants, particularly for corporate governance, audit quality and other firm specific characteristics. However, the

understanding would substantially lead to this study in predicting the direction of the hypotheses (potential consequences).

Chapter 4

Earnings Quality, Firm Valuations and Development of Hypotheses

4.1 Introduction

In this chapter, the main hypotheses are developed for empirical testing. It begins with reviewing the literature on the association between RP transactions and earnings quality (discretionary accrual), and the effect of RP transactions on firm valuation and performance. Chapter 2 described the nature of RP transactions and theoretical framework that underlay RP transactions. That discussion showed RP transactions had the potential to be used opportunistically by senior executives for their own gain. Chapter 3 shed light on the unique ownership structure and institutional backgrounds in East Asian countries facilitating RP transactions. The chapter also reviewed the determinants of RP transactions and how these led to more suspect financial dealings.

The chapter is organized as follows. The next section discusses earnings quality and the literature on the association between RP transactions and discretionary accruals. At the end of this section, I discuss the first hypothesis and its sub-hypotheses. Section 4.2 discusses previous studies' findings on the effect of RP transactions on business valuation. At the end of the section, I discuss the second hypothesis and its sub-hypotheses. To conclude, section 4.3 summarizes the chapter's main themes.

4.2 Earnings Quality

Earnings quality is defined as features that represent decision usefulness in specific decision context. Higher earnings quality more faithfully represents the features of a firm's fundamental business processes (Cheng & Lo, 2006). The scope of a decision's usefulness differs from context to context. The concept of earnings quality has roots in the judgmental nature of accounting whereby different parties may interpret the economics underlying a transaction differently, and different firms may have different business characteristics. However, there is no single best proxy used to measure earnings quality that is appropriate for all business decision contexts. Dechow, Ge, and Schrand (2010) contend that earnings quality proxies include a firm's performance, discretionary accruals and earnings management, share return, and accuracy of earnings forecasts. In this study, I use discretionary accruals as the proxy for earnings quality.

4.2.1 *Discretionary Accruals (DAC)*

Earnings disclosed in the financial reporting may be biased because earnings are manipulated by managers or controlling shareholders. Users of financial reporting may be aware that accounting figures may be subjected to manipulation by managers and lead to questions about the quality of such earnings. Although Wang and Yuan (2012) suggests managerial discretion improves the ability of earnings to reflect a fundamental value in the United States marketplace, it may indicate managers' opportunistic behavior in obtaining earnings. Major accounting scandals and corporate failures may also indicate that top executives manage earnings aggressively, through accounting sleight-of-hand and corporate policies designed to improve their firms' performance (Chen et al., 2011). Managing

earnings via accruals for any reason can lead to false financial statements and affect resource allocation.

In order to examine whether earnings have been managed corruptly, researchers have to measure the effects of accounting discretion in unexpected (discretionary context) with some degree of margin of error. To estimate discretionary accruals, Jones (1991) examined total accruals that are measured as the difference between reported net income and cash flows from business operations. Total accruals are then regressed on variables that are proxies for normal accruals such as revenues changing to allow for typical working capital needs; for example, receivables, inventory, and trade credit, gross fixed assets which allow for normal depreciation. Thus, the discretionary accruals are represented by the residual components of total accruals²⁴. Despite some weaknesses in the Jones (1991) model, Dechow, Sloan, and Sweeney (1995) use its parameters in the pre-event period for each firm, and apply those to a modified sales change variable to compute discretionary accruals in the event period. This model is defined as the modified Jones model that can estimate discretionary accruals in a time-series framework. Discretionary accruals have been employed in several analyses to represent earnings management (Burgstahler & Eames, 2006; Erickson & Wang, 1999; Teoh, Welch, & Wong, 1998; Teoh, Wong, & Rao, 1998) that suggest a manager's intention to manage earnings is driven by many incentives.

²⁴ Jones (1991) introduced this approach via the Jones Model. However, several studies have questioned its reliability, such as Guay et al., (1996) and Beneish, (1998).

4.2.2 Incentives for Accruals Management

Understanding the incentives is essential for understanding a manager's behavior. Friedlan (1994) and Wang (2006) suggest that earnings manipulation may be induced by managers wanting to increase their wealth by raising the value of stock retained and cash receipts from the partial disposition of existing stock. Prior researchers have examined many different incentives for managing accrual being derived from capital market expectations or valuations, written contracts, and regulators or government regulations (Lo, Wong, & Firth, 2010b). Wang (2006), and Burgstahler and Eames (2003) show that investors' and financial analysts' needs to share value/price information can become incentives for managers to manipulate earnings via accruals in an attempt to influence short-term share price performance²⁵.

Many studies have examined written contract incentives as how accounting data can be used to help monitor and regulate the contracts between a firm and its stakeholders. Healy and Palepu (1990), DeAngelo, DeAngelo, and Skinner (1994), and DeFond and Jiambalvo (1994) analyze whether written debt contracts can stop a manager gaining benefit from the firm's stockholders at the expense of its creditors. Dechow and Sloan (1991) and Holthausen, Larcker, and Sloan (1995) use compensation contracts to identify whether there is an alignment between the incentives of management compensation and external stakeholders²⁶.

²⁵ Their studies have examined whether managers "overstate" earnings in periods prior to equity offers. The findings indicate that firms report positive (income-increasing) unexpected accruals prior to seasoned equity offers (Teoh, Welch, & Wong, 1998), initial public offers (Teoh, Wong, & Rao, 1998), stock-financed acquisitions (Erickson & Wang, 1999). Teoh, Wong, and Rao (1998) and Erickson and Wang (1999) find a reversal of unexpected accruals following initial public offers and stock financed acquisitions, respectively. Burgstahler and Eames (2003) conclude that firms manage their earnings to meet analysts' forecasts.

²⁶ Healy and Palepu (1990), and DeAngelo et al. (1994) conclude that there is little evidence of earnings management among firms close to their dividend covenant. DeFond and Jiambalvo (1994) and Sweeney (1994) examine a sample of firms that actually violated a lending covenant. The evidence is mixed. DeFond

Any form of regulation gives firms or managers incentives to enjoy personal incentives, bonus-related pay, benefits from shares and share options (compensation-based earnings management). It is consistent with the argument that managers will shift earnings from a future period to a current period to maximize their financial benefit (Healy, 1985; Watts & Zimmerman, 1986).

Some studies found that accounting discretion is used to manage industry-specific regulatory constraints such as bank overstated loan loss provisions, understated loan write-offs, and recognize realized gains on securities portfolios (Beatty, Chamberlain, & Magliolo, 1995; Collins, Shackelford, & Wahlen, 1995; Scholes, Wilson, & Wolfson, 1990). Some earlier studies also examine the likelihood of accrual earnings management due to regulative scrutiny, including Jones (1991) and Cahan (1992)²⁷, and to achieve an earnings target or certain requirements (Chen et al., 2011; Chen & Yuan, 2004).

Avoidance of reported losses and earnings decline is the most important incentive of managers to manage accruals. Burgstahler and Dichev (1997), Holland and Ramsay (2003), Leuz, Nanda, and Wysocki (2003), Bhattacharya, Daouk, and Welker (2003), Mohd-Saleh et al. (2005) speculate that corporate managers want to avoid reporting losses or reporting declines in earnings. These studies examine the distribution of reported earnings to identify

and Jambalvo (1994) find that firms accelerate earnings one year prior to the covenant violation. Sweeney (1994) also finds that covenant violation leads to income increasing accounting changes, but these take place after the violation. Healy (1985) and Holthausen et al., (1995) show that firms with caps on bonus awards are more likely to report accruals that defer income when that cap is reached than firms that have comparable performance but which have no bonus cap.

²⁷ Jones (1991) finds that firms in industries seeking import relief tend to defer income in the year of application. Cahan et al., (1992) provide evidence that firms under investigation for anti-trust violations reported income-decreasing abnormal accruals in investigation years.

the potential of earnings management. Their findings²⁸ could be interpreted consistently as firms potentially use the discretionary accrual to avoid reporting negative earnings, or earnings decline or below market expectations. Prior studies also show the managers organize earnings in such a way to avoid reporting losses that are driven by market perceptions so that trends are maintained or to meet analysts' earnings forecasts (Barth, Elliott, & Finn, 1999). Other incentives include securing a management position or better job security (DeFond & Park, 1997), and for initial public offerings (Aharony, Lee, & Wong, 2000; Aharony et al., 2010).

4.2.3 RP Transactions, Discretionary Accruals, Real Earnings Management and Development of hypotheses

Accounting discretions enable managers or controlling shareholders choices to recognize or to delay recognition of transactions for certain purposes. Agency conflict in an organization that may arise either due to conflict of interest between managers and shareholders or controlling shareholders and minority shareholders can drive opportunistic earnings manipulation, including transactions with related parties. There is an argument that RP transactions will indicate the likelihood of aggressive accounting (Sherman & Young, 2001). McCahery and Vermeulen (2011) emphasize that the relationship between two related parties can influence the way RP transactions operate. For example, they undertake operating RP transactions at below or higher than market price or shift profits between group members immediately. This is called RP transaction-based earnings management.

²⁸ Burgstahler and Dichev (1997) have compelling evidence that about 30% to 44% of managers are managing earnings to avoid reporting losses. Holland and Ramsay's (2003) study supports the above finding by showing evidence that managers of Australian firms manage earnings for the same reason. Mohd-Saleh et al., (2005) find significant incidence for Malaysian listed firms reporting positive earnings while avoiding the publication of losses. This evidence is consistent with that of previous studies, see Burgstahler and Dichev (1997) and Holland and Ramsay (2003).

Healy and Wahlen (1999) emphasize that managers can manipulate earnings not only through accrual manipulation; they can also structure transactions, including RP transactions to alter a firm's financial reports. Some RP transactions-earnings management studies such as Jian and Wong (2010) and Chen et al. (2011) examine both accrual and real operating RP transactions. This is consistent with the nature of RP transactions that are associated with tunneling or propping up activities. Nevertheless only a few studies have investigated the links between RP transactions and accruals earnings management, particularly in East Asian countries.

Cheung et al. (2009) and Jian and Wong (2010) demonstrate that managers manage earnings through tunneling²⁹ or propping up by structuring a transaction with related parties, particularly the group-affiliate firms. Jian and Wong (2010) examine a sample of Chinese publicly listed firms from 1998 to 2002 and find that abnormal RP sales are not entirely accrual-based but can be cash-based as well. They also conclude that there is significant cash transfer via related lending from listed firms back to their controlling owners. The evidence indicates that Chinese businesses are diverting the money they obtain from operations to their own firms. They also find that earnings manipulation through tunneling activity is more pronounced for group-controlled firms. Jian and Wong (2010) also examine the association between RP transactions and discretionary accruals, but they find no association between RP transactions and accruals earnings management.

²⁹ Johnson et al. (2000) describe tunneling as "the transfer of assets and profits out of firms for the benefit of those who control them". This term relates to parent firms exploiting minority shareholders by siphoning off economic resources from IPO firms.

Chen et al. (2011) provide examples of RP transactions-based earnings management by controlling shareholders in the context of post-IPO long-term performance in China. They argue that firms can manipulate pre-IPO earnings either through manipulating discretionary accruals or structuring artificially operating RP transactions with controlling shareholders to boost sales and/or profits in order to increase the offered share price. They use 257 Chinese A and B share IPO for 1999 and 2000. The results suggest that controlling shareholders structure the operating RP transactions and also utilize accruals management in the pre-IPO period. They find that RP transactions are positively associated with a company's operating performance. When the controlling shareholders discontinue these RP transactions-based earnings management practices in the post-IPO period, they find that the positive relationship between IPO firms' operating performance and the size of operating RP transactions disappears. This finding indicates that the operating RP transactions decline after the IPO contributes to a firm's post-IPO long-term poor performance. The evidence empirically demonstrates that RP transactions are used as earnings management tools, including accruals and real operating management.

Aharony et al. (2010) find evidence that the managers' opportunistic behavior to manage earnings upward in the pre-IPO period may be motivated by the prospect of tunneling opportunities in the post-IPO period. They use a sample of 185 Chinese IPO firms listed on the Shanghai Stock Exchange during 1999-2001. They find that RP sales of goods and services could be used opportunistically to manage earnings upwards in the pre-IPO period, and the parent firms exploit minority shareholders by not repaying outstanding corporate loans obtained from these IPO firms. They also provide evidence to support their assertion

of a link between such tunneling behavior in the post-IPO period and earnings management via abnormal RP sales in the pre-IPO period.

Thomas et al. (2004) emphasize that firms may engage in earnings management through transactions with affiliated firms instead of relying on accrual manipulation. The corporate group usually consists of a complex of interlocking ownership and multiple cross-holdings through subsidiaries. The affiliates may also have subsidiaries or equity investment entities that further complicate profitability. Financial statement users will have difficulty in determining the extent to which parent firm earnings are affected by affiliate transactions, especially when the transaction details are not disclosed sufficiently. For example, managers or controlling firms may use their influential relationship with an affiliate firm to structure transactions between the two firms to shift profits from the affiliate to their own firms. As a result, the controlling firms will report higher profits, and the affiliate will report lower profits at the equal amount, though it would remain profitable to the groups as a whole. Therefore, it is very unlikely that investors and other stakeholders will be able to detect the RP transactions-based earnings management. Users of the controlling firm will be misled by the profit reported in the group's financial report. Furthermore, the profitability of RP transactions between a parent firm and its affiliates is not separately disclosed in the parent company's financial report. The information about the profitability of the affiliate firms also may be unavailable if the affiliate firm is wholly owned or not publicly traded. Thus, an affiliate transaction is a more potentially useful earnings management technique (Gao & Kling, 2008).

Thomas et al. (2004) use transactions with affiliate firms belonging to Japanese listed firms for 1985-2000 to examine earnings manipulation. They argue that when the parent firm dominates affiliate firms, the parent firm can structure transactions between itself and the affiliates in a way to manage consolidated earnings. They use abnormal (magnitude changed) to measure each type of RP transaction. The findings indicate that the parent firm manages firm and group earnings around three earnings thresholds: avoiding losses, avoiding earnings decline and avoiding negative forecast errors. They also find evidence indicating that earnings manipulations around these three thresholds are associated with the ability to use affiliate transactions for parent earnings, while consolidated earnings as a whole is unaffected.

Gordon and Henry (2005) report the evidence from the U.S. that the related parties engaging in the transactions may have incentives to manage earnings either to justify (increase or decrease) these perquisites or possibly to mask such expropriation via accruals. They find adjusted absolute abnormal accruals are positively associated with limited types of transactions such as fixed-rate financing from related parties. Overall the findings warrant more concern that RP transactions may become tools for earnings manipulation. The evidence supports that RP transactions can indicate that accounting information is subjected to aggressive accounting practices (Gordon & Henry, 2005; Sherman & Young, 2001). Park and Park (2004) and Sawicki and Shrestha (2008) support the notion that current discretionary accruals are larger for firms whose managers sell their ownership in the subsequent period than for other firms, indicating that managers have deliberately increased

current-period earnings through accruals management³⁰. This kind of earnings management can be interpreted whereby the controlling shareholders exploit economic resources from minority shareholders for their own benefit.

Apart from the Chinese and U.S. evidence, Munir and Mohd-Saleh (2009), Kuan et al. (2010) and Sumiyana and Rahmat (2012) assess the association between RP transactions and earnings management among developing countries in South-East Asia. These studies use discretionary accruals as a measure of earnings management. Kuan et al. (2010) examine a sample of 50 publicly listed firms for the period 2004 to 2005 find that RP transactions are not associated with earnings management, while Sumiyana and Rahmat (2012) find the opposite in their sample focus in Indonesia.

Munir and Mohd-Saleh (2009) examine the relationship between RP transactions and earnings management (discretionary accruals) among Malaysian publicly listed firms. They find that certain RP transactions of such firms have a positive relationship to earnings management. The authors also find evidence suggesting that family controlled firms use specific RP transactions to expropriate the wealth of minority shareholders by transferring profits and cash to themselves. This is consistent with an entrenched view that the controlling family wants to protect its own interests rather than those of the investors (Anderson & Reeb, 2003a; Morck et al., 1988; Villalonga & Amit, 2006). Specifically, while controlling families have small fractions of ownership, the firms are likely to report high performance. The controlling families have incentives to maximize value, and this

³⁰ Although Park and Park (2004) and Sawicki, & Shrestha (2008) examine insider trading (not RP transactions), their evidence does highlight opportunistic managers behavior in managing earnings via accruals.

incentive coincides with the interests of other shareholders. However, when the level of family ownership and control becomes dominant, the family's businesses could experience conflict of interests between controlling family and minority shareholders.

The performance of family controlled firms is expected to be poor due to the expropriation activities occurring through RP transactions (Anderson & Reeb, 2003b; Claessens et al., 2002; Lemmon & Lins, 2003). Therefore, concealing the poor performance is an incentive for controlling firms to manage earnings more deceptively (Leuz et al., 2003). As a result, the earnings quality reported by these firms would be poor because the earnings are unlikely to reflect the true performance of the firms and will lead to misleading financial statements (Dechow & Schrand, 2004; Schipper & Vincent, 2003). Nevertheless, prior empirical evidence for the association between RP transactions-accruals based earnings management and controlling families is limited.

There are issues with employing different measurements use in prior studies focusing on RP transactions and accruals. Kohlbeck and Mayhew (2004) utilize the disclosure of types and natures of RP transactions as being either simple or complex. Gordon and Henry (2005) draw on a number of different types RP transactions, different related-parties, the amount disclosed and their complexity. Jian and Wong (2010) utilize RP sales for their recurring nature to determine the normality or abnormality of RP transactions. Munir and Mohd-Saleh (2009) employ magnitudes of RP transactions over total assets while Kuan et al. (2010) use the absolute amounts and number of RP sales to measure RP transactions. These different measurements resulted in inconsistent findings. Instead of the magnitude strategy, I use

abnormal RP transactions, which are consistent with Aharony et al. (2010). They use abnormal specific types of RP transactions to examine the association between RP transactions and real earnings management. Previous studies have not found evidence from the broader international perspective. For this reason a cross-country study should explore the link between RP transactions and quality of earnings, particularly in East Asian economies. This gap in the knowledge provided a substantial motivation for this thesis.

Managers have many reasons for choosing non-conservative or income-increasing accounting methods. Examples include executive compensation³¹ and bonuses where managers may wish to increase reported profits (Gaver, Gaver, & Austin, 1995); debt covenants where managers may want to increase reported profits and decrease reported liabilities (Defond & Jiambalvo, 1994), and raising new equity or debt finances where managers want to emphasize strong profitability (Friedlan, 1994). Managers, therefore, have incentives in some circumstances to recognize potential gains early and to defer recognition of losses to later periods. Managers can choose aggressive accounting practices so that RP transactions emerge as selling assets or buying assets from related parties, and loans to or loans from them. It is consistent with the nature of RP transactions that are complex and easily manipulated by opportunist managers (Sherman & Young, 2001).

In many cases RP transactions are often carried out at non-arms-length due to their nature, which usually favor related parties. They can manage the earnings through accrual-specific RP transactions or create and disclose non-existent RP transactions. Here, I argue that the

³¹ Executive compensation and remuneration are categorized as a type of RP transaction (Kohlbeck & Mayhew, 2010).

higher magnitude of RP transactions will increase the likelihood that the earnings are biased, less accurate and misleading. In this case, a firm's involvement in RP transactions reduces earnings quality. The literature suggests that the association between RP transactions and real earnings management is more established (Cheung et al., 2006; Cheung et al., 2009; Jian & Wong, 2010; Aharony et al., 2010; Chen et al., 2011). However, prior studies that primarily test RP transactions-accrual based earnings management are limited, and the results are mixed.

This review draws attention to several aspects that may require further study as the existing evidence does confirm managers' opportunistic behaviors (Cheung et al., 2009; Cheung et al., 2006; Gao & Kling, 2008). Gordon and Henry (2005) find a positive relationship between RP transactions and discretionary accruals based on U.S publicly listed firms. Regarding Chinese listed firms, Jian and Wong (2010) find an association between RP transactions and propping up activities, but they do not find one with discretionary accruals. Aharony et al. (2010) find a positive association between specific RP transactions and earnings management in Chinese IPO firms, but they use a different model to measure accrual management. Evidence of an association between RP transaction and accrual management in East Asian countries that have weak shareholder protection is limited. Earlier studies such as Munir and Mohd-Saleh (2009) in Malaysia, and Kuan et al. (2010) and Sumiyana and Rahmat (2012) in Indonesia may provide the initial starting point for future research to understand RP transactions-accrual based earnings management behavior. I summarize the prior studies about earnings management via RP transactions in Table 3.1.

Table 3.1
Summary of Selected Literature on RP Transactions and Earnings Management

Studies	Country	Purpose of Study	Data and Method	Findings
Thomas, Herrmann, and Innoue (2004)	Japan	Examine firms engage in earning's management through structuring transactions between parent's firms with their affiliates in a way to achieve income-reporting objectives.	Real earnings management. Use 10,804 firm/year observations over the period 1985-2000 (Japanese firms). Three objectives to be achieved: avoiding losses, avoiding earnings declines, avoiding negative forecast errors.	They find earnings management behaviour for both parent and consolidated earnings around three thresholds avoiding losses, avoiding earnings declines, and avoiding negative forecast errors. The evidence shows that the increased of parent firm's earnings around these three earnings thresholds are related to the firm's ability to use affiliated transactions.
Gordon and Henry (2005)	US	Investigate the association between RP transactions and earnings management.	Use number, parties involved & dollar amount of RP transactions for 331 firms in the year 2000 and 2001. Use adjusted absolute abnormal accruals.	The adjusted absolute abnormal accruals are positively associated with limited types of transactions such as fixed-rate financing to related parties. The evidence warranted RP transactions as a factor associate with earnings managements via certain types of RP transactions.
Cheung, Rau, and Stouraitis (2006)	Hong Kong	Examine connected transactions between firms and their main shareholders or directors who could lead to expropriation and substantiate the presence of real tunnelling in the Hong Kong stock market.	Use Hong Kong listed firms during 1998-2000. Tunnel through real operating-earnings management.	They find that minority shareholders experience significant value losses when companies undertake connected transactions. The data allow exploring in detail the mechanisms through which the expropriation takes place.

Table 3.1
Summary of Selected Literature on RP Transactions and Earnings Management (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Munir and Mohd-Saleh (2009)	Malaysia	Examine the effect of RP transactions on earnings quality of Malaysian firms with substantial family ownership.	Employ discretionary accruals (DAQ) and performance adjusted current discretionary accruals (PACDA) to measure earnings quality. Use 236 listed firms with substantial family ownership in the year 2004.	Earnings quality of firms with huge family ownership becomes much lower when they undertake RP transactions that suggesting controlling families may expropriate the minority shareholder of the firms via RP transactions. They find consistent results for both earnings quality's measure, i.e., DAQ and PACDA.
Cheung, Jing, Lu, Rau and Stouraitis (2009)	China	Examine tunnelling or propping up RP transactions between Chinese listed firms and their controlling shareholders during 2001-2002.	Use 292 filings by listed companies to Chinese's stock exchange authorities during 2001-2002. Operating earnings management. Classify RP transactions into three groups as a potential of tunnelling and potential of tunnelling or potential of propping.	They find evidence that firms manage earnings through tunnelling or propping up by structuring a transaction with related parties. Propped up firms tend to have worse operating performance in the fiscal year preceding the announcement of the RP transactions. They also find that RP transactions representing tunnelling are accompanied by significantly less information disclosure compared to RP transactions representing propping.
Kuan, Tower, Rusmin, and Van-der-Zahn (2010)	Indonesia	Examine the association between RP transactions and earnings management.	Use 50 Indonesian listed firms for the periods 2004-2005. Use total discretionary accruals (TAC) to represent earnings quality. Use absolute value of RP transactions.	They find that there is no statistically significant evidence of the association between RP transactions and earnings management. The evidence suggests that the mere presence of RP transactions in Indonesian companies does not necessarily indicate that the management engages in greater earnings management.

Table 3.1
Summary of Selected Literature on RP Transactions and Earnings Management (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Jian and Wong (2010)	China	Examine listed firms prop up earnings by using RP transactions.	Use Chinese's listed firm from 1998 through 2002. Utilize both real operating earnings management and discretionary accruals.	Find evidence that listed firms prop up earnings by using abnormal RP sales to their controlling owners, which is more prevalent among state-owned firms and in the region with weaker economic institutions. There is a significant cash transfer via related lending from listed firms back to controlling owners after the propping (based on operating earnings management). No cash transfer via related lending is found to be associated with accrual's earnings management.
Lo, Wong, and Firth (2010)	China	Investigate whether good governance structures help constrain management's opportunistic behaviour in the form of transfer pricing manipulations.	Use 266 companies listed on the Shanghai stock exchange in the year 2004. RP sales transactions.	They find that firms with a board that has a higher percentage of independent directors or a lower percentage of "parent" directors, or have different people occupying the chair and CEO positions, or have financial experts on their audit committee, are less likely to engage in manipulating RP transactions' transfer pricing. The evidence suggests that the good quality of corporate governance is important in deterring the use of manipulated transfer prices in RP sales transactions.

Table 3.1
Summary of Selected Literature on RP Transactions and Earnings Management (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Aharony et al. (2010)	China	Examine the post-IPO share price performance for the newly issued firms and document return under performance for a firm that engaged in earnings management in the pre-IPO period and subsequent tunnelling in the post-IPO period.	Use 185 newly listed Chinese-IPO firms during the period 1999-2001. Use abnormal RP Sales & Services. Real operating-earnings management.	RP sales of goods and services could be used to manage earnings upwards in the pre-IPO period. It is motivated by the prospect of tunnelling from minority shareholders for the parent firm's benefit. The evidence supports an association between such tunnelling behaviour in the post-IPO period and earnings management via abnormal RP sales in the pre-IPO period. They find that the non-repayment by Chinese's parent firms of net outstanding corporate loans made to them by their newly listed subsidiaries as one tool of tunnelling. The findings enhance understanding of the motives for and consequences of earnings manipulation during the IPO process.
Chen, Cheng and Xiao (2011)	China	Examine RP transactions-based earnings management by using accruals and real earnings management through structuring a transaction with related parties to alter firm's financial reports.	Use Chinese A-share and B-share IPOs firms that first trading day were between 1 January 1999 and 31 December 2000 due to the availability of RP transactions' data since 1997-1998.	The findings demonstrate that controlling shareholders create operating RP transactions in pre-IPO period, and these RP transactions are positively associated with firm's operating performance. The decline in operating RP transactions' post-IPO results in long term under performance and negatively affects firms' stock return.
Yeh, Shu, and Su (2012)	Taiwan	Explore how corporate governance affects the level of RP transactions and how it moderates the motives of using RP transactions in Taiwan, and concentrated ownership.	Use all listed firm in Taiwan's stock market in the period of 1996-2008. RP sales, RP lending, RP guarantees, and RP borrowing.	They find that the tunnelling hypothesis and the propping hypothesis indicating that abnormal RP sales are used for meeting earnings targets. Since these abnormal RP sales can be cash-based, there is significant cash transfer via related lending from listed firms back to controlling owners.

Corporate governance reforms and amending regulatory frameworks in East Asia may specifically curb the abusive RP transactions if they are effective and do improve shareholder protection. However, there is no empirical evidence supporting the view that such reforms are successful. Jensen and Meckling (1976) approach to corporate governance attempt to address the conflict interest between shareholders and management. Developments in corporate governance theory have also highlighted in-depth form of conflict of interests that is action being taken by the managers or controlling shareholders for their own benefit, at the expense of minority shareholders (Johnson et al., 2000). Directors, managers or controlling shareholders have incentives to manage earnings to increase or legitimate their perquisites or to hide such wealth expropriation.

Based on the discussion in Chapter 2, 3 and chapter 4, I expect agency conflict would be more apparent in this context of RP transactions, particularly in the firms with controlling shareholders. RP transactions may turn out to be a useful tool for managing earnings (Jian and Wong 2008; Aharony et al. 2005). This study argues that information asymmetry is the main source of agency conflict in preparing a firm's financial reports (Fama & Jensen, 1983; Jensen & Meckling, 1976), and it is a primary incentive for managers to manage accruals. Thus, I predict that a positive relationship between RP transactions and discretionary accruals, which will reduce earnings quality. Based on the above argument, Hypothesis 1 is proposed:

H1: There is a negative relationship between RP transactions (based on magnitude and abnormal measures) and earnings quality (based on discretionary accruals and performance-based discretionary accruals).

4.2.3.1 Types for RP Transactions

This study recognizes that varying types of RP transactions may affect earnings quality differently. This recognition will provide a greater understanding of the potential problems and benefits for every type of RP transactions, which is associated with efficient and legal contracting or illegal opportunism. Most prior studies that investigate the association between RP transactions, and earnings manipulation uses specific types of RP transactions such as RP sales or purchases (Aharony et al., 2010; Jian & Wong, 2010; Munir & Mohd-Saleh, 2009). Cheung et al. (2006) classify RP transactions according to their potential to be used for tunnelling or propping up a firm's wealth. They argue that each type of such transaction is potentially treated by the managers differently. Each type of RP transactions can be used in varying ways by managers or controlling shareholders to manage accruals.

Kohlbeck and Mayhew (2010) categorize RP transactions based on the complexity of the transactions. They include RP complex as sales or purchase of goods/inventory or assets, providing or receiving services, reimbursement or receiving of cash and others. While RP simple refers to straight-forward transactions, including legal and consultancy services, rental and leases services, loan and guarantees to or and other types of transaction with related parties. They find no evidence that complex transactions with investments, such as joint venture, related business activities and overhead reimbursement plans that often involve many accounts in the financial statements, including receivables and payables, are linked to opportunism. Opportunist managers or controlling shareholders may utilize the complex nature of RP transactions to manipulate earnings because it is difficult to trace it.

Gordon & Henry (2005) examine a relationship between purchases of goods and/or contract services acquired from, and sales to related parties and earnings management. Although they find that adjusted absolute abnormal accruals (AAAC) are associated with certain types of transactions, but they do not find any association for the component of RP complex. Jian & Wong (2010) utilize RP sales to examine the association between RP transactions and earnings management represented by real operating and discretionary accrual (DAC). They find evidence suggesting the relationship between RP sales and real operating earnings management but do not find evidence for DAC. Lo et al. (2010) provide evidence that showing firms manipulate RP sales transfer pricing with related parties' firms.

Aharony et al. (2010) examine RP sales of goods, and services could be used opportunistically to manage earnings upwards in the pre-IPO period. They find evidence suggesting that RP sales of goods/services one such opportunistic tunneling tool. Chen et al. (2009) find that RP purchase has a significantly positive impact on ROA. This evidence suggests that firms engage in more purchase transactions with related parties to boost firms' operating performance (ROA). Additionally, Munir & Mohd-Saleh (2009) utilize asset acquisition, asset's sales, equity sales, trading relationship to examine the relationship between RP transactions and discretionary accruals. The evidence shows that these components of RP complex are associated with discretionary accruals. Even, the results from prior studies are mixed; I develop the following hypothesis as consistent with the theory.

H1a: There is a negative relationship between RP complex (based on magnitude and abnormal measures) and earnings quality (based on discretionary accruals and performance-based discretionary accruals).

There evidence shows an association between RP simple transactions such as leases, rental, legal advice, consultation or others (non-RP loans) and earnings manipulation is limited. Kohlbeck and Mayhew (2010) have evidence linking straight-forward transactions with related parties such as leases, consulting and legal fees, and loans with insider opportunism. Chen et al. (2011) provide evidence showing that firms structure operating RP transactions involving leases, franchises, royalty and administrative overheads, and loan to increase earnings in IPO process. Gordon & Henry (2005) also find a relationship between the adjusted abnormal accruals and fixed-rate financing from related parties. However, there is no similar association for other types of RP transactions. Kuan et al. (2010) also include straight-forward transactions with related parties to define RP transactions such as borrowing and lending, interests, rents, purchase & sales commissions, and exchange of fixed assets. They find no association between RP transactions and discretionary accruals. Aharony et al. (2010) provide evidence that firms exploit minority shareholder's wealth by not repaying outstanding corporate RP loans during the post-IPO period. Consistent with the theory that managers or controlling shareholders may have incentives to manage earnings, I propose the hypothesis below:

H1b: There is a negative relationship between RP simple (based on magnitude and abnormal measures) and earnings quality (based on discretionary accruals and performance-based discretionary accruals).

Additionally, I test RP loan separately from other components of RP simple. Chen et al. (2009) examine the impact of RP transactions that consist of RP loan, RP guarantee, RP lease and others on firm's operating performance (ROA). They find no evidence that

suggesting the firms do not manipulate RP transactions to increase operating performance. However, a separated test for each type of RP transactions shows that RP loan and RP lease have a significant association with ROA. Thus, I propose the following hypothesis:

H1c: There is a negative relationship between RP loan (based on magnitude and abnormal measures) and earnings quality (based on discretionary accruals and performance-based discretionary accruals).

4.3 Firm Valuation and Performance

Earnings are assumed as a value relevant³² if they can capture and summarize firm value or explain the stock market (Qiang, 2007) and has a predicted association with equity market values (Firth, Rui, & Wu, 2009)³³. Warfield, Wild, and Wild (1995) and Vafeas (2000) also support the contention that earnings usefulness is represented well by its association with market returns. This assumption is consistent with Ball and Brown's (1968) recognition that examining equity share price behavior is an effective way to study investment behavior in large groups of investors.

Investors and shareholders are external parties with limited voting rights so that they cannot directly prevent any abusive transactions being entered into by managers or controlling shareholders, including RP transactions. If the investors perceive that earnings are

³² Value relevance is an empirical operationalization of these criteria because an accounting amount will be value relevant, i.e. have a predicted significant relation with share prices, only if the amount reflects information relevant to investors in valuing the firm and is measured reliably enough to be reflected in share prices. Then, only if an accounting amount is relevant to a financial statement user is it able to make a difference to that user's decisions (Barth et al., 2001). Means, test of value relevance is one approach to operationalize the FASB's stated criteria of relevance and reliability.

³³ Value relevance is measured as the statistical association between financial statement information and stock market values or returns. The relevance and reliability of accounting amounts are reflected in equity values i.e. equity values reflect an accounting amount if the two are correlated (Barth et al., 2001).

manipulated (in this case, via RP transactions), one option for them is to sell or refuse to buy the stock of related-party firms, or file ex-post litigation against opportunistic insiders or related parties (Kohlbeck & Mayhew, 2010). Thus, shareholders and investors have an interest in the firm value (Kothari, 2001), particularly in either to buy or sell stock, and whether the decision made will result in security price changes.

4.3.1 Brief Review of Studies on Firm Valuation

The use of financial statements as the major medium of communication with their equity shareholders and public at large has motivated firm valuation studies. Stock market regulators and accounting standards setters also need empirical evidence to improve the quality of transparency in financial reporting. One objective of preparing a financial report is to provide useful accounting information to assist investors in equity valuation. Accounting information is assumed to be useful from the perspective of equity investors if it is values relevant; the accounting numbers must be related to current firm value. It cannot be classified as value relevant if the information is not able to determine a firm's value because financial reports are unable to fulfill one of the primary objectives. This concept of firm valuation is consistent with Francis and Schipper (1999) who define value relevance as the ability of financial statement information to accurately capture and summarize information that determines the firm's value.

Firm valuation research has been done since the late 1960s by Ball and Brown (1968) and Beaver (1968). Ball and Brown (1968) explored the relationship between stock prices and information disclosed in financial statements. They use an event study to look at abnormal

returns in the months before and after earnings announcement dates. They conclude that income has an informativeness value, which captures half, or more of all the information about an individual firm that is then available during a whole financial year. However, the annual income report is not a very timely one because most of its contents are documented before the earnings' announcement dates, historically based on a twelve month period.

While Beaver (1968) finds evidence that indicates a rapid increase in trade volume of shares during the week of announcements, this is much larger than the average during the non-reporting period. Both findings suggest that earnings announcements lead to changes in the probability distribution of future returns for investors. Beaver concludes that the information content of income is significant. In principle, Beaver (1968) tests general sensitivity of stock prices to the magnitude of reported earnings. Meanwhile, Ball and Brown (1968) focus on the unexpected stock price changes and earnings. Since then a number of studies investigated firm valuation in various accounting information contexts, mainly dividend, book equity and earnings. Empirical research on firm valuation has its roots in the theoretical framework on equity valuation models³⁴.

Amir, Harris, and Venuti (1993) first used the term value relevance in the context of information content of accounting figures. The accounting figure or ratio is the value relevant if it has a significantly strong predicted association with stock prices and stock market indicators like price-earnings (P/E) or price to book (P/B) ratios. Ohlson (1995) states the value of a firm can be expressed as a linear function of book value, earnings and other value relevance information. Prior studies emphasize the usefulness of earnings

³⁴ See Ohlson (1995), Feltham and Ohlson (1995) and others.

assisting investors and shareholders in making their investment decisions. Stein (1989) notes investors and shareholders use earnings information to invest and forecast future earnings. Conceptually, therefore, an amount of earnings as reported in the financial statement must have relevant and predictive value (Ball & Brown, 1968; Beaver, 1968; Francis & Schipper, 1999) and should be a more representative value driver (Aboody, Hughes, & Liu, 2002). This is consistent with the main objectives of financial reporting, i.e. to provide investors with information that is relevant to estimating a firm's value. Active investors would refer to financial statement analysis to ensure that the value of firms is worth evaluating for the respective share prices accurately.

The intensity of earnings value relevance differs from country to country (Alford, Jones, Leftwich, & Zmijewski, 1993; Ali & Hwang, 2000; Ball, Kothari, & Robin, 2000; Bushman & Piotroski, 2006; Fan & Wong, 2002; Hung, 2000), and East Asia is no different (Ball, Robin, & Wu, 2003; Fan & Wong, 2002)³⁵. Such studies imply two explanations to clarify the associations between stock returns and earnings value relevance. First, earnings quality in reflecting information about future benefits varies across countries and results in differences in the value relevance of earnings. Second, the ability of stock prices to impound information also differs internationally as the accounting earnings are a subset of that information.

³⁵ Alford et al. (1993) use earnings information in the US as a benchmark, and discover that the information content of earnings is different from country to country. They argue that the difference in value relevance of earnings is due to different financial reporting requirements, disclosure, government regulations and corporate governance systems. Fan and Wong (2002) show that earnings value relevance has a negative association with the ownership concentration in Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand. Furthermore, Ball, et al. (2003) emphasize that the four common law economies in Asia - Malaysia, Singapore, Hong Kong, and Thailand, - have fewer timely earnings than other common law countries. They suggest that the quality of earnings is reduced due to poor incentives of managers and auditors even the four countries have high-quality accounting standards. Firm valuation studies are many but the study of the association between firm valuation and RP transactions is limited at this stage, particularly for East Asia.

4.3.2 *RP transactions, Firm Valuation and Performance*

Investors may worry that the RP transactions have been manipulated by managers to boost their current earnings. Such concerns do not draw much attention until the revelation of RP transactions as did occur at Enron and Adelphia. These accounting scandals increased investor's awareness that RP transactions can encourage managers or controlling shareholders to extract a firm's wealth at the expense of other stakeholders. The main concern is that RP transactions are carried out in a non-arms-length and usually favoring related parties. They can manage the transaction by structuring specific RP transactions or create and disclose non-existent RP transactions. The managers or controlling shareholders can generate benefits by selling assets, goods or services to the connected firms at a price higher than the market price or otherwise, buying it from the affiliated parties at a price lower than the market price. They can also structure a transaction that favors related parties, including RP loans (La Porta, Lopez-de-Silanes, & Zamarripa, 2003) or provide guarantees for personal RP loans (Johnson et al., 2000). Profits and assets can be transferred via transactions between firms in the same group³⁶. The managers or controlling shareholders' involvement in RP transactions leads to wealth expropriation that could severely damage shareholders' interests. Thus, RP transactions may affect the usefulness of earnings for making decisions, at the expense of minority shareholders.

Although managers disclose necessary information, the investors and stakeholders cannot prevent corrupt RP transactions. Kohlbeck and Mayhew (2010) emphasize that investors have limited rights to vote at shareholders' meetings for companies subject to controlling

³⁶ Profits of the affiliated firms can be transferred to parent firms or the way around. These firms' profits can be expropriated to affiliated firm via RP transactions.

shareholders. What they can do is deal with shares in the market by selling or refusing to buy shares of firms that deal with related parties. The low demand in the stock market could discount the share price and lead to a reduced firm valuation. If investors are alert to the likelihood of wealth being expropriated through RP transactions, a lower valuation for firms involve in RP transactions should be expected.

Consistent with the above prediction, most research in the U.S. and China supports the assertion that RP transactions lead to a low firm value (Ge et al., 2010; Gordon et al., 2004; Kohlbeck & Mayhew, 2004; Kohlbeck & Mayhew, 2010; Ryngaert & Thomas, 2007; Ryngaert & Thomas, 2012). In contrast, the evidence for East Asia is limited. Based on the U.S. data set, Gordon et al. (2004) find industry-adjusted returns have a negative link with RP transactions. They also find a negative relationship between the returns and the number and dollar amount of loans to executives and non-executives directors, and between the numbers of other types of RP transactions with non-executive directors.

Ryngaert and Thomas (2012) investigate the frequency, nature and effects of RP transactions in a sample of small firms in four industries before and after a counterparty becomes a related party. Their results suggest that RP transactions are not harmful if not used opportunistically. However, the transactions initiated after the counterparty becomes a related party are associated with reduced shareholders' wealth. They also find evidence showing that firms have less valuation if key positions are given to family members. This evidence strengthens the argument that RP transactions support the conflict of interest view. In another study, Kohlbeck and Mayhew (2010) investigate the valuation of U.S. firms that

disclosed RP transactions just prior to the Sarbanes-Oxley Act (SOX) banning RP loans, to evaluate a market's perceptions of firms engaged in RP transactions prior to regulatory intervention. They use several firm valuation models, including Tobin's Q and residual income model (RIM), concluding that RP transactions have a negative relationship to Tobin's Q and market value of equity. Based on the RIM, they also find that the weighting of interaction between RP transactions and residual income has a negative relationship to market value of equity. These findings suggest that the market values of firms engaging in RP transactions are significantly less than firms not involved in RP transactions.

Nekhili and Cherif (2011) came to similar conclusion regarding French publicly listed firms. They examine the impact of RP transactions carried out by the firm directly with the main shareholders, directors and /or managers on firm value, during the period 2002-2005. Their findings support the conflict of interest transaction as they have a negative influence on firm value. However, I argue the above U.S. findings and those of France cannot be generalized internationally, particularly to East Asia countries for specific reasons. In the US corporate governance practices are more advanced and effective and protection of all shareholders is much stronger. Furthermore disclosure standards are much higher than in East Asia.

In China, firm valuation research by Deng et al. (2006), Tong and Wang (2008), Cheung et al. (2009), Jian and Wong (2010), Aharony et al. (2010) and Ge et al. (2010) produced consistent results, suggesting that RP transactions between Chinese firms are engaged in conflict of interest. Deng et al. (2006) document that RP transactions being abused by large shareholders to expropriate resources at the expense of minority shareholders. They also

find evidence that large shareholders use dividend policy to keep the firm's resources under their control. Ge et al. (2010) examine the value relevance of firms that disclose RP sales of goods and RP sales of assets. They use 52 manufacturing firms in China for the period 1997-2000 which was prior to the '2001 RPT Measurement Regulation'. They find that the coefficient of interaction between earnings and RP sales of assets and interaction between earnings and RP sales of goods is negative and significant. However, the coefficient on interaction between earnings and RP sales of assets is larger than the coefficient on interaction between earnings and RP sales of goods. This implies that investors perceive RP sales of assets are more severe, thus discount the earnings more when observing RP sales of assets than RP sales of goods. This means that RP sales of goods usually involve inventory transactions with the subsidiaries, associated firms and/or joint-ventures that could fulfill businesses' daily operations. Therefore, the investors may perceive that RP sales of goods are not abused as a whole.

Cheng and Chen (2009) examine the association between RP transactions and firm valuation in the context of an initial public offering (IPO). They find that long-term IPO stock performance is substantially associated with the change in operating RP transactions from pre- and post-IPO. The IPO firm reports a decline in operating RP transactions significantly compared to other industry players. The evidence shows that the valuation of the firm engaged in RP transactions is less, and an increase in volume of RP transactions leads to worse business value. This can be interpreted as investors perceiving RP transactions being used to expropriate wealth from the firms by related parties. This discourages investor's

interests and forces them to discount the stock price of businesses engaged in RP transactions.

RP transactions are more likely to occur in firms where the main shareholders have both the incentive and power to expropriate minority shareholders' wealth. Using their voting rights, controlling shareholders can indulge in transactions that are favorable to them and to the detriment of minority shareholders. Prior studies indicate that investors perceive a low valuation for firms engaged in transactions with controlling shareholders. Cheung et al. (2006) state that firms announcing RP transactions with controlling shareholders earn significantly negative excess returns and significantly less than firms announcing similar arm's-length transactions. They use a sample of 375 RP transactions between Hong Kong listed firms and their controlling shareholders and directors during 1998-2000. It is evident that RP transactions are linked to lower share returns.

Tong and Wang (2008) examine the relationship between RP transactions and controlling shareholders according to convergence and entrenchment hypotheses. Their conclusion is consistent with the entrenchment effect when the share ratio of controlling shareholders is less than 50%. The controlling shareholders are likely to pursue private benefits by utilizing RP transactions through profits adjusting, earnings management and so on, which are unfair to other minor shareholders. Otherwise, the controlling shareholders prefer utilizing RP transactions for pursuing shared benefits of control when the ownership is more than 50%. Nevertheless, those findings also cannot be generalized internationally to the emerging Asian market countries. Most of the listed firms in China are state-controlled and the

government substantially influences the decision-making process and how businesses are done (Jian & Wong, 2010). Evidence from other East Asia countries is limited. Munir and Gul (2010) in Malaysia contend that family-controlled firms are involved in RP transactions with lower firm valuations.

Other studies have measured the effect of RP transactions on a firm's operating performance such as returns on asset (ROA) or returns on equity (ROE). Overall, the findings suggest that RP transactions compromise the firm's operating performance. Chen and Chien (2007) examine the impact of corporate governance where there is a mitigating effect of RP transactions on performance. An interaction between a firm's unitary leadership (CEO duality) and RP transaction negatively affects company performance. Berkman et al. (2009) provide evidence regarding the relationship between tunneling and financial performance. They find that the ROA and dividend yield are significantly lower and the leverage is substantially higher, at firms that issued related guarantees. The recent evidence from Malaysia in the study by Abdul-Wahab et al. (2011) finds that RP transactions are negatively related to a firm's operating performance. They also find that good corporate governance practices could reverse the adverse impact of RP transactions on firm performance.

Studies have shown that the implementation of specific regulations on RP transactions may be effective in curbing corrupt or illegal transactions, see Atanasov et al. (2010) and Ge et al. (2010). Practicing good corporate governance could also limit wealth expropriation through RP transactions. Gallery et al. (2008), Gao and Kling (2008), Gul et al. (2010) and Chien and Hsu (2010) emphasize that audit quality can mitigate the problems caused by RP

transactions, such as via external monitoring. It is a concern that the corporate governance reforms and amendment of the regulatory frameworks in East Asian countries should rebuild investor's confidence in authentic of RP transactions. However, there is no empirical evidence to date supporting that governance reforms improve investors' reliance on financial reports issued by the firms involved in RP transactions.

4.3.3 Firm Valuation Models

Several models were developed to measure the effect of RP transactions on firm valuation. Aharony et al. (2010), and Tong and Wang (2008) use share price, share returns, share ratio or abnormal share returns models to examine a direct relationship with RP transactions. These studies find that RP transactions have a negative association with share return and abnormal share return. The evidence demonstrates that an increase in volume of RP transactions lessens firm valuation. This can be interpreted as investors perceiving RP transactions being used by related parties to opportunistically expropriate wealth, and consequently, shrink their interests. Consequently, investors discount the stock price of such firms.

Warfield et al. (1995) use the earnings-returns based model to examine the effect of managerial ownership on earnings informativeness. Based on agency theory, they explain that the informativeness of earnings and management behavior varies systematically with the level of management ownership in a firm. They find the correlation between stock return and accounting earnings is significantly greater for a firm with higher managerial ownership, suggesting that managerial ownership has a positive association with informativeness of

earnings. Analyses by Fan and Wong (2002), Yeo, Tan, Ho, and Chen (2002), Donnelly and Lynch (2002), and Sánchez-Ballesta and García-Meca (2007), extend this to various contexts of managerial ownership. Their results suggest that the lower ratio of shares held by managers contributes to enhancing the informativeness of earnings and constrains earnings manipulation.

At a higher level of management ownership, the relationship is reversed, showing some potential of conflict between shareholders and managers leading to moral hazard. In another study, Ahmed, Hossain, and Adams (2006) examined the effect of board size and board independence on informativeness of earnings using New Zealand companies for the period 1991-1997. They find earnings informativeness that is defined as a relationship between earnings and share return is negatively related to board size. The result suggests a smaller board of directors is more effective than a larger one for monitoring earnings informativeness. In contrast, board independence does not appear to be significant.

This evidence suggests that the informativeness of earnings is well represented by its association with the stock returns (Fan & Wong, 2002; Sánchez-Ballesta & García-Meca, 2007; Warfield et al., 1995). However, empirical evidence for the effect of RP transactions on the informativeness of earnings is limited. Wang and Yuan (2012) is the only study to date that extends this model in the context of RP transactions. They argue that RP sales may violate the arms-length assumption of regular transactions and consequently, impair the representational faithfulness and verifiability of accounting information. Using a random sample consisting of 140 Chinese listed firms, they find that earnings of firms engaged in RP

sales are at least 33% less informative. This evidence suggests that RP sales of goods and services adversely impact on the usefulness of accounting earnings to investors. However, further research is required to enlarge the literature, particularly for East Asia and more internationally.

A Tobin's Q is another measure widely used by Dahya et al. (2008), Berkman et al. (2009), Kohlbeck and Mayhew (2010), Nekhili and Cherif (2011), and Ryngaert and Thomas (2012). These studies consistently exhibit a negative coefficient for the association between RP transactions and Tobin's Q, suggesting that RP transactions weaken firm performance. The results are consistent within the context of family-controlled firms (Munir & Gul, 2010) and from an international perspective (Dahya et al., 2008). It can be interpreted that the results consistently suggest investors perceive RP transactions negatively, as they may be used opportunistically to expropriate their wealth. Consequently, lowered valuations of firms involved in RP transactions will occur.

Elsewhere, Kohlbeck and Mayhew (2010) and Ge et al. (2010) use firm valuation models based on Ohlson's (1995) model. Ge et al. (2010) construct a model based on Barth et al. (2001) and (Beaver, 2002) to examine the impact of RP sales of goods and RP sales of assets on earnings value relevance. Kohlbeck and Mayhew (2010) use a residual income model that is reintroduced by Ohlson (1995) and Feltham and Ohlson (1995). The effect of RP transactions is determined using the coefficient of the interaction between RP transactions and earnings. Both Kohlbeck and Mayhew (2010) and Ge et al. (2010) conclude that the coefficient of interaction between earnings and RP transactions is negative and significant,

suggesting that an increased volume of RP transactions will decrease the firm value. Again, the evidence is limited to the U.S. and China, thus requiring further study, particularly in East Asian companies.

Studies used earnings-returns-based events to examine the effect of RP transactions, such as Kohlbeck and Mayhew (2010) in the US and Utama and Utama (2009) in Indonesia. This model is based on the market or investors' reactions to stock due to an announcement where a firm engages in RP transactions. Kohlbeck and Mayhew (2010) argue that the lower valuations are caused by the market having already developed expectations of negative consequences due to RP transactions. Utama and Utama (2009) find that the cumulative abnormal returns (CAR) surrounding the date of announcements is lower for a related party's firms than non-related firms. They also find a similar association for firms in group affiliations than for those in non-group affiliations. Kohlbeck and Mayhew (2010) employ cumulative annual return (CAR) on the three-day windows surrounding each event, but they did not find any difference, suggesting that RP transactions announcements do not affect investors in firms that engage in RP transactions, differently.

The Tobin's Q model, value relevance model (Barth, Beaver, & Landsman, 1998; Barth et al., 2001; Ohlson, 1995) and earnings informativeness model (Warfield et al., 2005) are well established. However, the use of these models in examining the effect of RP transactions is limited, particularly the earnings-value relevance and earnings informativeness models. It is essential to find further evidence that could strengthen the impact of RP transactions on

earnings-value relevance and informativeness of earnings. The most crucial is empirical evidence in East Asia countries and not just rely on examples from the U.S. and China.

The majority of prior firm valuation studies such as Dahya et al. (2008), Kohlbeck and Mayhew (2010), Ge et al. (2010), and Nekhili & Cherif (2011) use a discrete variable to measure RP transactions, whether disclosed or non-disclosed. It is highly relative in determining RP transactions are corrupt when only based on companies disclosing or non-disclosing such transactions. The use of the dummy variable also cannot differentiate a magnitude (dollar amount) of the transaction because the amount of US\$100, US\$1,000, or US\$1,000,000 would be exercised and interpreted similarly as 1. Furthermore, at the international level the financial reporting standard and the listing requirements of the stock exchange force firms to disclose their RP transactions differently. Alternatively, continuous measures such as a magnitude (threshold) or a magnitude change of the RP transactions are more precise in determining the effects, specifically in a cross-country analysis. As a response to Gordon et al. (2007), in order to use RP transaction in manipulating financial reporting the firm will favor appointing auditors who have a close relationship. Prior studies have ignored this relationship but it requires further consideration in future research. Instead, size of audit firm, tenure auditor-client engagement may become better measurements represent the close relationship.

I argue that most evidence may be influenced by the revelation of RP transactions appearing in many large accounting scandals. This argument is consistent with Kohlbeck and Mayhew (2010) who are concerned that the revelations emerging from such scandals may limit their

findings. Majority of studies uses data sets of information disclosed in financial reporting for years that are closest to the revelation of the abused RP transactions in many large corporations' accounting scandals, including those of Gordon et al. (2005), Kohlbeck and Mayhew (2010), Cheung et al. (2009), Chen et al. (2011). High profile RP transactions appeared in the press and media regularly and this extensive media focus may have increased the market's sensitivity to RP transactions. As a result, market participants may already perceive or expect negative consequences as a result of RP transactions (Kohlbeck & Mayhew, 2010).

Instead of state control in China, corporations and group of families dominate the majority of listed firms elsewhere in East Asia via block or concentrated ownership (Claessens et al., 2000; La Porta et al., 2000). Mitton (2002) and Friedman et al. (2003) also emphasize a lack of legal protection for shareholders, particularly minority shareholders and sets up a conducive landscape for potentially illegal RP transactions. Managers or controlling shareholders can make contracts with related parties; where an inefficient market exists. Nevertheless, evidence from other East Asia is very limited (see Abdul-Wahab et al., 2011; Munir & Gul 2010; Utama & Utama 2009). As the potential of expropriation increases, market participants will show their concern by discounting the share price or firm value of related-party firms. A large comparative analysis of emerging countries could lead to a better understanding of the valuation of firms practicing RP transactions. I summarize the prior studies about the impact of RP transactions on firm value in Table 3.2.

Table 3.2
Summary of Selected Literature on RP Transactions and Firm Valuation

Studies	Country	Purpose of Study	Data and Method	Findings
Gordon, Henry and Palia (2004)	US	Investigate the association between corporate governance mechanisms and RP transactions. Investigate the association of RP transactions with firm value.	112 listed firms in the year 2000 and 2001, is selected from COMPUSTAT. Industry adjusted returns. RP loan and other type of RP transactions.	They find weaker corporate governance mechanisms associated with more and higher dollar amounts of RP transactions. RP transactions are negatively associated with industry-adjusted returns. They also find a negative relationship between industry-adjusted returns and the number and dollar amount of RP loan to executive and non-executive directors. Similar results are found between industry-adjusted returns and other type of RP transactions.
Cheung, Rau, and Stouraitis (2006)	Hong Kong	Examine connected transactions between Hong Kong listed firms and their controlling shareholders. Determine whether the market anticipates the expropriation by firms.	Data use from the 1998, 1999 and 2000 issues from Hong Kong Listed Companies database. Abnormal stock return. Differentiate types of RP transactions based on potential of expropriation.	On average, they find that firms announcing connected transactions earn negative excess returns significantly lower than firms announcing similar arm's length transactions. They also find limited evidence that firms undertaking connected transactions trade at discounted valuations prior to expropriation. It is suggesting that investor cannot predict expropriation and can only revalue the firms when expropriation does occur.
Dahya, Dimitrov, and McConnell (2008)	Cross-country	Investigate the relation between corporate value and board composition in firms with a dominant shareholder, particularly in a context of firms' engagement in transaction with related parties.	Utilize 799 firms with a dominant shareholder across 22 countries. Tobin's Q.	The occurrences of RP transactions are negatively correlated with the board composition made up independent directors. A higher proportion of independent directors is associated with a lower likelihood of the firm engage in RP transactions. They also find that the occurrence of RP transactions is associated with lower valuation (Tobin's Q). Firms without RP transactions have higher values than firms with RP transactions.

Table 3.2

Summary of Selected Literature on RP Transactions and Firm Valuation (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Berkman, Cole and Fu (2009)	China	Determine a potential of wealth expropriation of Chinese's firms through loan guarantees to related parties.	Utilize 88 Chinese listed firms. RP loan guarantee. Tobin's Q, ROA, dividend yield.	They find that the identity and ownership of block holders affect the likelihood of expropriation. There is evidence shows a relation between tunnelling and proxies for firm value and financial performance. They find Tobin's Q, ROA, and dividend yield is significantly lower, while leverage is significantly higher at firms that issued RP loan guarantees.
Utama & Utama(2009)	Indonesia	Investigate whether stock price reactions in response to investment announcement made by firms listed on the Indonesian Stock Exchange.	Use announcement of investment decisions from 1 January 2000 Until 31 December 2005. Involve 229 merger associations and 105 material transaction announcement (Events studies). Cumulative abnormal returns (CAR) & Tobin's Q.	Find that the stock price reaction (CAR) for RP transactions is lower than for non-RP transactions. Suggesting that market perceived RP transactions is subject to wealth expropriation by controlling shareholders. They also find that the CAR for firms in group affiliations is lower than those in non-group affiliations.
Atanasov, Black, Ciccotello, and Gyoshev (2010)	Bulgaria	Examine how law can control two forms of equity tunnelling through dilutive equity offering and freezouts; and how equity tunnelling risk can affect firm valuation.	Data use throughout the year 2002 from Bulgarian listed firms. Profitability (ROA) and Tobin's Q. Emphasize the effect at pre & post the implementation of new regulation on equity tunnelling by related parties.	Before implementation of law, investors rationally discount the prices they pay for the shares, and may not participate in dilutive share offerings if they lack legal protection again freezouts. After the law being implemented has a large effect on share values as Tobin's Q levels for high-equity-tunnelling-risk firms rise sharply, relative to low risk. It can be interpreted as evidence of controllers substituting from equity tunnelling into greater cash flow tunnelling.

Table 3.2
Summary of Selected Literature on RP Transactions and Firm Valuation (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Munir & Gul (2010)	Malaysia	Examine the association between RP transactions and firm performance, particularly among family firms in Malaysia.	Use 462 listed firms in Bursa Malaysia in the year 2004 and 2005. Tobin's Q & ROA	They find RP transactions are negatively associated with firm performance. The association is stronger for family firms than non-family firms. Suggesting that family firm's engagement in RP transactions increase a likelihood minority shareholders' wealth expropriation.
Ge, Drury, Fortin, Liu and Tsang (2010)	China	Examine the value relevance of disclosed RP transactions in Chinese corporations.	Use 52 manufacturing firms over the period 1997 to 2000 and 2001-2003. Use share price model before and after the implementation of new regulation in the year RP sales of goods & RP sales of assets.	From 1997 to 2000, they find that reported earnings of selling goods or assets to related parties exhibit a lower valuation than those of firms in China without such transactions. From 2001 to 2003, they find that the negative association is not observed after the new RP transactions regulation is implemented. Suggesting that the new RP transactions' regulation is perceived to be effective at reducing the potential misuse of RP transactions for earnings manipulation purposes.
Kohlbeck & Mayhew (2010)	US	Examine the stock market's valuation of the firms that disclose RP transactions compared to those that do not.	Use 1,194 firms that disclose RP transactions in 2001 prior to the fraud revelation & Sarbanes-Oxley Act amendment in 2002. Use Tobin's Q, earnings-market valuation, and expected share returns.	They find that RP firms have significantly lower valuations and marginally lower subsequent returns than non-RP firms. Market perceptions differ based on partitioning firms by RP transactions' type and parties. The evidence is consistent with the market discounting firms that engage in simple RP transactions than complex RP transactions

Table 3.2

Summary of Selected Literature on RP Transactions and Firm Valuation (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Nekhili & Cherif (2011)	France	Investigate the impact of RP transactions on firm value. Identify the ownership and governance characteristics of firms that engage in this type of transactions.	Use the 3SLS simultaneous model. Utilize 85 firms listed on the Paris Stock Exchange during the period 2002-2005. Firm value: Tobin's Q	RP transactions are mainly influenced by the voting rights held by the substantial shareholder, the size of the board of directors, the degree of independence enjoyed by the audit committee and the board of directors, the choice of the external auditor, the debt ratio and the fact of being listed in the USA. RP transactions have a negative influence on firm value, mainly the transactions carried out directly with the substantial shareholders, directors and/or managers. Suggesting that the frequency of RP transactions can be damaging and destroying to firm's market value.
Lei and Song (2011)	Hong Kong	Investigate tunnelling through RP transactions using a dataset of Chinese's firms in Hong Kong.	Use 181 China-affiliated firms on the Hong Kong Exchange on or before 31 October 2004. Firm value: Tobin's Q & market to book value, cumulative abnormal returns (CAR).	They find that firm value is significantly lower for firms undertaking potentially expropriating transactions. Cumulative abnormal returns are lower for RP transactions with disclosure exemptions and negatively related to some RP transactions' types. Suggesting that firms tunnel using RP transactions with disclosure exemptions and that disclosure requirements matter for RP transactions. It could signal that investors substantially discount firms that undertake potentially expropriating transactions.
Abdul-Wahab, Haron, Lok and Yahya (2011)	Malaysia	Investigate the relationship between RP transactions, corporate governance, and firm performance.	Use 448 firm-year observations for 2005-2007. Use corporate governance as the moderating variable.	They find that RP transactions are detrimental to shareholders and thus reducing firm performance. The negative effect is mitigated by the presence of good governance such as board independence and executive remuneration. They also find auditor size could reduce the negative impact of RP transactions.

Table 3.2

Summary of Selected Literature on RP Transactions and Firm Valuation (continued)

Studies	Country	Purpose of Study	Data and Method	Findings
Ryngaert & Thomas (2012)	US	Investigate the implication of RP transactions for the outside shareholders differ based on the historical origins of the transactions.	Use small and medium-size firms. Tobin's Q & operating profitability. Analyse ex-ante verse ex-post RP transactions.	They find that the overall volume of disclosed RP transactions is not significantly associated with shareholder wealth, measured by operating profitability or Tobin's Q. The findings provide support for the efficient contracting hypothesis. They find evidence that ex-post RP transactions are negative, significantly associated with operating profitability. The average abnormal stock returns also significant and negatively associated with ex-post RP transactions. The market is viewing these transactions as reducing shareholder wealth.
Wang & Yuan (2012)	China	Investigate the impact of RP sales of goods and services on the usefulness of earnings to investors and on the quality of earnings forecasts by financial analysts.	Use 140 firms listed on the Shanghai Stock Exchange in 1997. Data is collected for seven years from 1998 to 2004 with the total of 980 firm-year observation. Share returns models.	They find that earnings of firms engaged in RP sales are at least 33% less informative after controlling for factors known to affect earnings informativeness. The evidence shows the financial analysts are over credulous in their acceptance of earnings numbers. They perceive that are contaminated by unreliable RP sales, and provide less accurate and more optimistic earnings forecasts for firms with more RP sales. Overall, the evidence strongly supports on the negative impact of RP transactions on the usefulness of accounting earnings data used by investors and financial analysts.

4.3.4 Development of Hypotheses

I develop the hypotheses by considering the nature of RP transactions and theoretical outlines that underpin the transaction (see Chapter 2), institutional background and determinants that motivate RP transactions (Chapter 3), and literature on RP transactions' consequences discussed earlier in this chapter. In general, consistent findings have been emphasized in previous studies and could be interpreted as confirming opportunistic transactions can be used expropriate wealth from firms. The costs of such transactions are borne by the shareholders. The nature of RP transactions as being often non-arms-length (over or under payment) reduces earnings that could be shared among the shareholders. This reduction is a cost that has to be paid by the shareholders, and turns into a loss. Shareholders do not have the ability to identify misstated or undisclosed RP transactions, including RP transactions. Therefore, they have to be more rigorous about alleged RP transactions that are hidden from shareholders.

A drawback is the shareholders do not possess a direct mechanism to impede RP transactions (Djankov et al., 2008). As an external party with limited voting rights, shareholders cannot prevent the managers or controlling shareholders from utilizing RP transactions. Disclosure requirements may either discipline managers' behaviors but ultimately disclosure itself does not prevent RP transactions (Kohlbeck & Mayhew, 2010). The presence of controlling shareholders also limits the investor's right to vote at the shareholder meeting. The only way investors can demonstrate their protest is through the stock market by selling or refusing to buy shares of firms engaged in RP transactions. If the market participants perceive that RP transactions increase the likelihood of their wealth

being expropriated by managers or controlling shareholders, existing shareholders may well decide to sell their shares. This study supposes that the low demand of the stock for firms dealing with related parties would lead to the firm's stock price shrinking. Prior studies consistently show evidence that the market forecasts lower evaluations for firms that disclosed their RP transactions (Gordon et al., 2004; Ge et al., 2010; Kohlbeck & Mayhew, 2010; Ryngaert & Thomas, 2012). Consistent with the theory and literatures discussed in Chapter 2, 3 and 4, the managers, directors or controlling shareholders may have the incentive to expropriate firm's wealth. Thus, I believe that RP transactions would increase potential of conflict of interest. I predict that the association between RP transactions and firm valuation in East Asia will reflect what previous studies found. The following hypothesis is proposed:

H2: There is a negative relationship between RP transactions (based on magnitude and abnormal measures) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness).

4.3.4.1 Types of RP transactions

Prior studies recognize that different types of RP transactions may impact on firm valuation differently. Gao and Kling (2008) use accounts receivable and payable to related parties, while Chang (2003) and Ge et al. (2010) employ RP sales of goods and sales of assets to examine its link to firm valuation. Although they find RP sales of goods and RP sales of assets are negative and significant, the coefficients of both RP transactions show a differentiation does exist. Thus, Cheung et al. (2006) and Kohlbeck and Mayhew (2010) use

a broad classification of RP transactions depending on the potential for expropriation³⁷ and the complexity³⁸ of the transaction, respectively.

Kohlbeck and Mayhew (2010) compose RP complex, including sales or purchases of goods/assets or services, and investment activity with related parties. However, they find RP complex transactions do not constitute clear evidence that suggests investors differentiate between RP complex and RP simple transactions. This evidence is consistent with Ge et al. (2010) in that the component of RP complex includes sales of goods (inventory) after the new RPT regulation became effective. RP sales of goods often refer to transactions with subsidiaries, associates or joint-ventures where the transaction could be seen as simply part of a business's daily operations. This evidence suggests the nature of each type of RP transactions is a basis for investors assessing the impact of such transactions.

Cheung et al. (2006) utilize components of RP complex in determining potential of tunneling such as acquisition/sale of assets, equity investments and others. Cheung et al. (2006) found that returns for the firms after 12 months following the announcement of these transactions were negative and significant. Ge et al. (2010) also find evidence that suggesting the investors discount earnings when valuing firms that engage in RP sales of goods and sales of assets (part of RP complex) before an implementation of the new RPT regulation. Another study, Lei and Song (2011) examine the impact of several types of RP complex such as acquisition/disposal of assets, acquisition/disposal of assets, and contractual agreement on

³⁷ Cheung et al. (2006) distinguish RP transactions into three broad categories of transaction that (1) expropriation wealth of minority shareholders (2) to the minority shareholders of the firms, and (3) carry out for strategic reasons and are assumed no purpose of expropriation.

³⁸ Kohlbeck and Mayhew (2010) classified the RP transactions into two groups based on a complexity of the transaction, RP complex and RP simple transactions. RP loan to executive directors is a component of RP simple transactions.

firm valuation. They find firms to involve in disposal of assets to, and contractual agreement with related parties suffers lower firm value. Based on the above discussion and Kohlbeck and Mayhew (2010) RP transaction classifications, this study posits the following hypotheses:

H2a: There is a negative relationship between RP complex (based on magnitude and abnormal measures) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness).

Kohlbeck and Mayhew (2010) define RP simple consists of consulting arrangement, legal advices, lease or rental, administrative services, and loan and guarantee to related parties. Kohlbeck & Mayhew (2010) find simple transactions to have a negative value. This evidence suggests that investors give lower valuation for firms engage in RP simple transactions. Baek et al. (2006), Cheung et al. (2006), Berkman et al. (2009), and Jian and Wong (2010) also demonstrate that RP loans and guarantee RP loans are the common methods of tunneling, and they seriously compromise the value of firms. Chen et al. (2009) find that RP other, which consisting of component of RP simple, including RP loan, RP Guarantee and RP lease is negatively significant with firm's market performance (Tobin's Q). Based on separate testing, the investors, specifically discount firms engage in RP lease and RP loan. These above findings indicate that investors perceive certain types of RP simple could be used opportunistically to expropriate firm's wealth. Consistent with the theory and prior studies, I propose the following hypothesis:

H2b: There is a negative relationship between RP simple (based on magnitude and abnormal measures) and firm value (based on Tobin's Q, earnings-market value and earnings informativeness).

Kohlbeck and Mayhew (2010) find evidence that showing RP loan and other RP simple transactions with directors generate the negative RP valuation association. They also find consistent association with the Tobin's Q for RP loan. Chen et al. (2009) also find that investors discount lower valuation for firms engage in RP loan, particularly in the presence of controlling shareholders. A recent study by Lei and Song (2011) also provide evidence that showing RP loan and guarantee has a negative relationship firm value (consistently for both measures, Tobin's Q and Market to Book Value). Thus, I propose the following hypothesis for RP loan as below:

H2c: There is a negative relationship between RP loan (based on magnitude and abnormal measures) and firm value (based on discretionary accruals and performance-based discretionary accruals).

4.4 Summary and Conclusion

This chapter provided a literature review on two different perspectives. The first reviewed the likelihood of RP transactions being used opportunistically by managers or controlling shareholders to manage earnings through accruals. The second is based on investors deeming that RP transactions are being used opportunistically by related parties. This reviews lead to the development of this study's hypotheses. Prior studies show that RP transaction-based earnings management can be accruals or cash-based, or a combination of them. The evidence is still limited but does indicate that managers and controlling shareholders utilize RP transactions to their own advantage. RP transactions have certain economic consequences and particularly on earnings quality. Some studies use firm performance such as ROA and ROE, while others use share returns to determine firm

valuation. The results are consistent in that indicate RP transactions support the view of conflict of interest transaction. There is no clear evidence supporting RP transactions are an efficient form of transaction unless after controlling certain corporate governance and implementation of new regulations.

While research on RP transactions is growing, this study finds that the evidence on the impact of such transaction from East Asia is limited. Most evidence is generated from research in the U.S., while evidence from the East Asia is dominated by what is happening in China. RP transaction research that uses data sets of listed firms Malaysia, Thailand, Hong Kong, Indonesia, Taiwan and India is still in its infancy and requires further exploration. In this chapter, two hypotheses and six sub-hypotheses are developed. Managers or controlling shareholders are predicted to use RP transactions efficiently or expropriate shareholders' wealth. The incentives exist obviously in the firms with poor corporate governance practice, regulatory framework and lack of shareholder protections, specifically in businesses dominated by controlling shareholders and where ownership is concentrated. Managers and controlling shareholders can potentially use accruals and restructure real RP transactions. Information asymmetry is the real explanation for a manager's or controlling shareholder's conflict of interest despite corporate governance reform developing in East Asia. This chapter also developed hypotheses according to investor's perceptions of the impact of RP transactions on firm valuation. Investors may be concerned RP transactions are used as tools for manipulating information in financial reports.

Chapter 5

Research Design

5.1 Introduction

This chapter presents a detailed discussion of the sample selection and research methodology. The literature on RP transactions-based earnings management involves several methods employed to measure earnings management, discretionary accruals, real operating, or combination of both methods. The literature on firm valuation also reveals alternative models employed to examine the impact of RP transactions. In this study, I investigate the effect of RP transactions from two different perspectives - internal (earnings quality) and external (firm valuation). I use discretionary accruals to measure earnings quality which is estimated by using Modified Jones (*DAC*) model developed by Dechow et al. (1995) and Performance-Matched Discretionary Accrual (*PMDAC*) model devised by Kothari, Leone, and Wasley (2005). I also use three different firm valuation models to measure the effect of RP transactions on firm valuation: firm performance (Tobin's *Q*), earnings-market valuation (*MVE*), and earnings informativeness (*RET*). The chapter will also identify the relevant explanatory variables.

The structure of this chapter is as follows: Section 5.2 outlines the selection sample of this study, and Section 5.3 outlines the proxies of earnings quality utilized here. Section 5.4 describes the models' construction to examine the association between RP transactions and discretionary accruals. It incorporates the *DAC* model based on Dechow et al. (1995), and

PMDAC model based on Kothari et al. (2005). The next section describes the three firm valuation models consisting of Tobin's Q, market valuation of equity, and earnings informativeness. Section 5.6 outlines the operationalization of variables. This section focuses on the measurement of those variables and finalizes the control variables to be included in these models.

5.2 Sample Selection

I select firms listed in Hong Kong, Malaysia, Singapore, and Thailand in order to test the effect of RP transactions on discretionary accruals and firm valuation. These countries are very important economically and have similar equity capital structures. They have also implemented reforms in corporate governance practices and various company-related statutes in the last decade. Most of the listed firms are typically dominated by controlling shareholders through block or concentrated ownerships, particularly by a group of families (Claessens et al., 2000; La Porta et al., 2000). The controlling shareholders usually occupy key managerial positions (Claessens et al., 2000; Sarkar et al., 2008). A founder and/or family members of the controlling shareholders often dominate the senior management positions in these controlled-firms (Claessens et al., 2000; Munir & Mohd-Saleh, 2009; Wiwattanakantang, 2001). These emerging economies are known as having weak corporate governance and regulatory frameworks that can protect the wealth of minority shareholders; this problem emerged clearly during the Asian financial crisis of 1997/1998 (Friedman et al., 2003; Mitton, 2002). The concentrated structure of ownership and the lack of monitoring control mechanisms make suspect RP transactions inevitable. The regulatory frameworks and corporate governance structures in many East Asian countries are being reformed to

counter abusive RP transactions³⁹. The required data of the listed firms over the period 2002-2010 and in English versions of their annual reports have sufficient samples for analysis.

I use both financial and non-financial data to test the hypotheses. I obtained the English version of annual reports for the period 2002 to 2010 from the OSIRIS⁴⁰ database. The annual reports and the financial statements of listed firms from Thailand were collected from the websites of the particular firms, the Stock Exchange of Thailand (SET), and the Securities Commission of Thailand (SEC). This study limits the analysis to 2007-2010 because the firms often disclosed RP transactions, mainly in the part of “Notes to Accounts” and some of the firms disclosed them in the “Director’s Report”. The data was also found in hard copy format because they were not available on OSIRIS database, particularly important aspects of corporate governance, ownership structure and audit quality. Specifically, this study uses sets of information from 2008 – 2010 to examine the magnitude and sets of information from 2007 – 2010 to examine the abnormal (magnitude change) RP transactions and its classifications. This study also requires annual reports’ financial statements for the period 2002-2006 to assess tenure of auditors with certain firms. Additional financial data for 2005-2007, and 2011 was also found, to estimate discretionary accruals and assess the potential of its reversal effects.

³⁹ Refer to Chapter 2 for the discussion about corporate governance reforms.

⁴⁰ OSIRIS Database is the primary resource of our data. Annual reports for 4 years (2007-2010) and financial statements for 5 years (2006-2002) are collected from the OSIRIS database. We screened the database by including companies that provide a complete set of the required annual reports and financial statements. We struggled to obtain a sufficient sample of Thailand listed firms because most firms supply only financial statements to the OSIRIS Database in the Thai language. The annual reports of those firms are also not completely available at the Stock Exchange of Thailand (SET) and Security of Commission, Thailand (SEC). We therefore browsed all these firms’ websites to find English versions of their annual reports. Conversely, these are available for listed firms in Hong Kong, Singapore and Malaysia.

I screened the database by including firms that provide a complete set of required annual reports and financial statements. This study excludes financial institutions, banks, and insurance companies because accruals in those regulated industries will differ substantially from other industries (Young, 1999). I then ranked the listed firms according to average firm size as at March 2011, over prior three years (2007-2009)⁴¹. I found that the number of listed firms that have English versions of annual reports that are available varied. Therefore, I selected about one-third of data in each economy by using the stratified random sampling method. This procedure ensures that the sample is representative and consists of a balance between large and small firms. Prior research suggests that the negative impacts of RP transactions are more obvious among small firms than large firms (Ryngaert & Thomas, 2012). The final sample was only confirmed at the end of June 2011 to ensure most annual reports for 2010 were available on OSIRIS or a company's website⁴². Finally, I obtained the annual reports for 2010 from the selected listed firms, but omitted a few due to them having an incomplete specific data⁴³.

These procedures yielded 423 listed firms over the three-year period and a total of 1,269 observations (see Table 5.1). The sample of this study consists of 51 listed firms from Hong Kong with 153 observations, 156 Malaysian listed firms with 468 observations, 112 Singapore listed firms with 336 observations, and 104 Thailand listed firm with 312 observations. The total final sample represents four (4) main industries: manufacturing (199 firms), retail (115 firms), services (38 firms), and properties (71 firms), which is based on

⁴¹ The total assets for the year 2010 are not included in calculating the average firm size because the data is not available for firms that prepared financial statements on 31 December 2010.

⁴² Majority companies are included in the sample close the accounts at 31 December 2010, thus the annual reports are expected available after March 2011. Most of the annual reports of Thailand listed companies are retrieved from the company's website.

⁴³ For example, there is firm disclosed the information use local currency other than MYR\$, SG\$, HK\$ or TH\$.

Global Industry Classification Standard (GICS) industry classification code. I merge two GICS industries, i.e. materials and industrials as manufacturing industry. The services industry includes energy, utilities, healthcare, and telecommunications while the retail industry comprises two GICS consumer industries, i.e. staples and discretionary.

Table 5.1
Sample Profile

Sample Firms by Country			Sample Firms by Industry		
Country	Firm	Total Observations	Industry	Firm	Total Observations
Hong Kong	51	153	Manufacturing	199	597
Malaysia	156	468	Retails	115	345
Singapore	112	336	Services	38	114
Thailand	104	312	Properties	71	213
Total	423	1,269	Total	423	1,269

Note: Total observations consists of three accounting periods (2008 – 2010)

Financial data is retrieved from OSIRIS using USD\$ currency. I also collect additional financial data for 2005 to 2007 and 2011. The additional data is used to estimate discretionary accruals for the pre- and post-analysis period, 2006, 2007 and 2011 to examine the potential of discretionary accrual's reversal effect. Data for RP transactions are collected from listed firms' annual reports in each economy's currency. The amount of RP transactions is converted into USD\$ using the exchange rate at the closing date of financial statements for each firm. The conversion rate is important because it limits the impact of fluctuation rate during the closing date. Finally, I classify the collected data of RP

transactions into either RP complex or RP simple according to the complexity of the RP transactions⁴⁴.

RP complex transactions are defined as transactions that typically involve many financial statement accounts and related parties, certain conditions, and impact on the financial statements in less obvious ways. These transactions include related business, unrelated business, overheads, and stock transactions, which usually involve transactions with subsidiaries, associates or affiliates, and joint ventures. RP simple transactions are defined as a straight-forward transaction that involves few financial statement accounts and related parties. RP simple includes loans, guarantees, borrowings, consulting, legal services, leases and others (see Appendix I). I also segregate RP loan transactions from RP simple transactions to examine the effect of RP loan separately. This separation is a response to the amended Malaysian Companies Act 1965 that banned RP loan transactions, while such transactions are not prohibited in Hong Kong, Singapore and Thailand. Please refer to Appendix II, III and IV to see examples of classification type of RP transactions.

5.2.1 Sample Distribution

Table 5.2 presents detailed information on RP transactions and distribution of the transaction according to the above classifications. RP transactions are very common in Thailand, as shown in Table 5.2, Panel A, where total RP transactions of listed firms represent 44.53% of this sample with a total US\$60.201 billion. Malaysian listed firms indicate a total RP transaction of US\$46.415 billion (34.33%), followed by Hong Kong with US\$26.645 billion

⁴⁴ The definition of complexity is based on Kohlbeck and Mayhew (2010).

or 19.71%. Singaporean listed firms disclosed the least amount of RP transactions, US\$1.928 billion (1.43%). The magnitude of RP transactions is considered substantial, specifically in Thailand and Malaysia. Panel A of Table 5.2 shows that Thailand's listed firms' involvement in an internal contract arrangement with related parties is almost 30% of their total assets, while in Malaysia, it represents 15.37% of total assets. Nevertheless, the total RP transactions only represent 5.9% of total assets of firms in the sample. In Hong Kong, a composition of RP complex and RP simple is moderately balanced at about 48.22%, and 51.78%, respectively. However, most RP transactions in Malaysian firms are RP complex, i.e. approximately 79.75% while RP simple is about 20.25%. Similarly, RP complex in Thailand is about 68.62% compared to RP simple (31.38%). In contrast, RP simple (66.64%) is more common among Singaporean listed firms than RP complex (33.36%). Table 5.2 also shows RP loans are apparent in Hong Kong (27.75%), Singapore (19.61%) and Thailand (14.04%), while in Malaysia, RP loans are only about 2.30%. The statistic for Malaysia may be due to the amended Companies Act 1965 in 2007 which banned RP loans. Consequently, there are no Malaysian listed firms disclosing RP loans during the period of this study, but some listed firms disclosed advances to related parties. Additionally, I classified and included the advances to related parties as RP loans. In Hong Kong, a component of RP simple is attributable to RP loan, where the magnitude of RP loan is larger than non-RP loan⁴⁵. In contrast the component of RP simple in Malaysia, Singapore and Thailand are non-RP loans, where the magnitude is 17.95%, 47.04%, and 17.34%, respectively.

⁴⁵ Component of RP simple can be classified into two groups either RP loans and non-RP loans (consisting renting, leasing, consulting and other straight-forward transactions)

Table 5.2
Distribution of RP Transactions

Panel A: Sample firms by country											
Country	Total RP Transactions			RP complex		RP simple					
	Amount (US\$ Mil)	Percentage of Total Observations	Percentage of Total Assets	Amount (US\$ Mil)	Percentage	Total		Non-RP loan		RP loan	
						Amount (US\$ Mil)	Percentage	Amount (US\$ Mil)	Percentage	Amount (US\$ Mil)	Percentage
Hong Kong	26,645	19.71%	1.93%	12,849	48.22%	13796	51.78%	6,402	24.03%	7,394	27.75%
Malaysia	46,415	34.33%	15.37%	37,015	79.75%	9399	20.25%	8,333	17.95%	1,066	2.30%
Singapore	1,928	1.43%	0.48%	643	33.35%	1285	66.65%	907	47.04%	378	19.61%
Thailand	60,201	44.53%	29.66%	41,310	68.62%	18892	31.38%	10,440	17.34%	8,452	14.04%
Total	135,189	100%	5.90%	91,817	67.92%	43372	32.08%	26,082	19.29%	17,290	12.79%

Panel B: Sample firms by industry											
Industry	Total RP Transactions			RP complex		RP simple					
	Amount (US\$ Mil)	Percentage of Total Observations	Amount (US\$ Mil)	Percentage	Total		Non-RP loan		RP loan		
					Amount (US\$ Mil)	Percentage	Amount (US\$ Mil)	Percentage	Amount (US\$ Mil)	Percentage	
Manufacturing	30,280	22.40%	22,639	74.77%	7,641	25.23%	5,545	18.31%	2,096	6.92%	
Retails	82,627	61.12%	59,740	72.30%	22,887	27.70%	14,388	17.41%	8,499	10.29%	
Services	16,195	11.98%	9,036	55.79%	7,160	44.21%	3,616	22.33%	3,544	21.88%	
Properties	6,086	4.50%	402	6.61%	5,684	93.39%	2,533	41.62%	3,151	51.77%	
Total	135,189	100%	91,817	67.92%	43,372	32.08%	26,082	19.29%	17,290	12.79%	

Total RP transactions are a combination of RP complex and RP simple. RP simple is classified into two components, RP loan and non-RP loan (other straight-forward transactions such as rental, lease, and consultations). Percentage of RP complex, RP simple, non-RP loan and RP loan are scaled to Total RP transactions for every country or industry. Percentages of Total Observations for every country are scaled to a total of RP transactions. Percentage of total assets refers to Total RP transactions of each country scaled to Total Assets of the listed firms in each country.

Panel B of Table 5.2 displays the distribution of the sample according to industry. Most RP transactions with a total of US\$82.627 billion (61.12%) are involved in retail, of which 72.30% transactions is RP complex. The manufacturing industry involves a total US\$30.279 billion that consists of US\$22.639 (74.77%) billion of RP complex and US\$7.641 billion (25.23%) of RP simple. I find a contradictory statistic in the properties industry, where RP simple represents 93.39% (US\$5.684 billion) of transactions compared to RP complex, i.e. 6.61% (US\$0.402 billion). RP loan transactions are common in all industries. The RP loan consists of US\$3.151 billion (51.77%) in the properties industry, US\$3.544 billion (21.88%) in the services industry, and US\$8.499 billion (10.29%) in the retail industry. The least number of RP loans is in the manufacturing industry and it only involves US\$2.096 billion or about 6.92% of the industry. The component of RP simple in the services industry is a balance between non-RP and RP loans. However, the component of non-RP loans is higher than RP loans in manufacturing and retail, and slightly lower in the properties industry.

5.3 Proxies of Earnings Quality and Firm Valuations

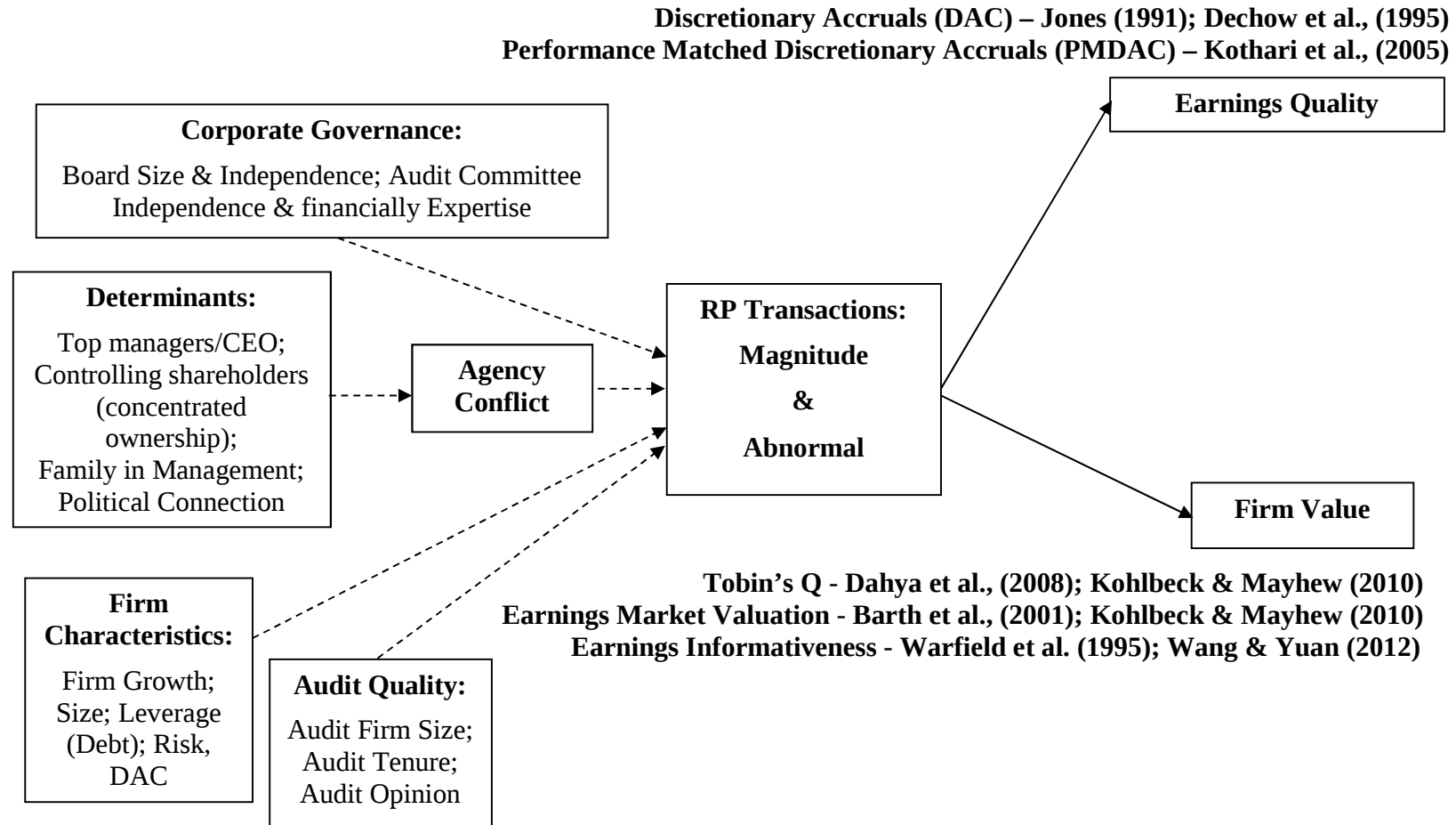
Earnings should contain features of the firm's basic business processes that represent decision usefulness in specific situations (Cheng & Lo, 2006). Earnings should also capture current value of the firms (Francis & Schipper, 1999). However, the decision-usefulness of earnings varies across different types of decisions and contexts. Many proxies have been used in other studies, including firm's operations and market performance, discretionary accruals and earnings management, share returns, value relevance, accuracy of earnings forecasts, etc. Some of these proxies are applied to investigate the effect of RP transactions on earnings quality and firm valuation. In summary, Chen and Chien (2007), Berkman et al.

(2009), and Abdul-Wahab et al. (2011) use operating performance such as return on assets (ROA), return on equity (ROE), dividend yield and leverage to represent earnings quality. Cheung et al. (2006), Aharony et al. (2010), Jian and Wong (2010), and Chen et al. (2011) explore the association between RP transactions and real earnings management. While there are only a few studies using discretionary accruals the results are mixed. Tobin's Q represents firm market performance and it is the most used in the RP transactions-valuation studies, such as Chen and Chien (2007), Dahya et al. (2008), Berkman et al. (2009), Kohlbeck and Mayhew (2010), and Lin et al. (2010). Some studies use share price or share returns-based models, for example Gordon et al. (2004), Nekhili and Cherif (2011), and Ryngaert and Thomas (2012). Only a few analyses use an earnings-value relevance (Ge et al., 2010), residual income model (Kohlbeck & Mayhew, 2010), earnings informativeness and earnings forecast (Wang & Yuan, 2012), and CAR for an event-based study (Utama & Utama, 2009).

I analyze the effect of RP transactions from two different perspectives, internal and external. The internal perspective refers to the managers or controlling shareholders' behavior concerning RP transactions, whether opportunistically or efficiently. I develop a model to examine the effect of RP transactions on earnings quality by using discretionary accruals as a proxy for earnings quality. I apply the *DAC* model (Dechow et al., 1995) and *PMDAC* model (Kothari et al., 2005) to estimate discretionary accruals. The detailed estimations of both are discussed in Section 5.4.1 and Section 5.4.2, respectively. Although Jian and Wong (2010) suggest that RP transactions-based earnings management studies should employ both accruals and real earnings management, I focus only on discretionary accruals.

Figure 5.1:

Theoretical Framework



Prior evidence shows that the association between RP transactions and discretionary accrual is limited⁴⁶, and this study also believes that an information asymmetry influences managers or controlling shareholders to control accruals. They typically have discretion over the recognition of accruals, and this discretion can be used to signal private information or to manipulate earnings. They also have the freedom to choose accepted accounting procedures to reflect the economics underlying the transactions or select accounting techniques to reflect accounting numbers for their personal benefit. In this way the financial information of reported earnings can be misleading, inaccurate, and biased. It is predicted that RP transactions-accrual management reduces earnings quality.

The external perspective investigates the potential effect of RP transactions on firm valuation from market players' perceptions. In this study, I use three different models to investigate the effect of RP transactions on firm valuations: Tobin's Q, earnings-value relevance (MVE), and earnings informativeness (RET). Their development is discussed in sections 5.5.1, 5.5.2, and 5.5.3. Warfield et al. (1995) suggest that the association between earnings and stock returns well represent the quality or firm valuation. Thus, the association is more useful because earnings elicit a stronger investor response, as reflected by security returns. The use of Tobin's Q will provide empirical evidence about business performance from an international perspective. The literature review also suggests evidence is lacking for the effect of RP transactions on earnings value relevance or earnings informativeness. The findings from this study could strengthen those of Kohlbeck and Mayhew (2010), Ge et al.

⁴⁶ Cheung et al., (2006), Aharony et al., (2010), Jian and Wong (2010) and Chen et al., (2011) explore the association between RP transactions and real earnings management.

(2010), and Wang and Yuan (2012). Based on the detail discussion in Chapter 2, 3 and 4, I illustrate a theoretical framework of this study in Figure 5.1.

5.4 Discretionary Accruals

I use discretionary accruals as a proxy of earnings quality. One advantage of using accruals to manage earnings is that it is difficult and costly for the users of financial reporting to unravel accounting numbers in order to make economic decisions. Managers or controlling shareholders benefit by information asymmetry and they are more likely using accruals to structure earnings deceptively rather than report on actual operating transactions. According to Healy and Wahlen (1999), discretionary accrual reflects opportunistic behavior where some accounting choices and estimates are to signal private information. I estimate discretionary accrual using the *DAC* model (Dechow et al., 1995) and *PMDAC* model (Kothari et al., 2005).

Studies on earnings management use the *DAC* model as the most suitable for estimating discretionary accruals. Dechow et al. (1995) have proven that the model is better than others in detecting induced manipulation⁴⁷. Consistent with the Jones (1991) model, some analyses partition total accruals into those resulting from managerial discretion (discretionary) and those that are not (non-discretionary). The partitioning components for firm *i* and time *t* are summarized below:

$$TACC_{it} = NDAC_{it} + DAC_{it}, \quad \text{Eq. 5.1}$$

⁴⁷The Healy (1985) model, the DeAngelo (1986) model, and the Industry Model by Dechow and Sloan (1991).

where, $TACC$ is total accruals; $NDAC$ is non-discretionary accruals, and DAC is discretionary accruals. $TACC$ for firm i and time t also can be computed based on the cash flow approach ($TACF$). $TACF$ is computed below as follows:

$$TACC_{it} = EARN_{it} - OCF_{it} \quad Eq. 5.2$$

where, $EARN$ is income before tax and extraordinary items and OCF is operating cash flows. $NDAC$ is predicted based on Jones (1991), in which the model explicitly controls for firms' performance (Dechow et al., 1995; Guay, Kothari, & Watts, 1996). The no intercept model for firm i and time t is described as the following equation:

$$TACC_{it}/TA_{it-1} = \beta_1(1/TA_{it-1}) + \beta_2(\Delta REV_{it}/TA_{it-1}) + \beta_3(\Delta PPE_{it}/TA_{it-1}) + \varepsilon_{it} \quad Eq. 5.3$$

where, $TACC$ is total accruals, TA_{it-1} is opening total assets, ΔREV_{it} is change in net revenue for firm i in year t , ΔREC_{it} is change in net for receivables for firm i in year t , PPE_{it} is property plant and equipment of firm i in year t , and ε is the prediction errors. Then, the abnormal accruals (DAC_{it}) are determined as the prediction errors (ε_{it}) from the following equation:

$$DAC_{it}(\varepsilon_{it}) = (TACC_{it}/TA_{it-1}) - \{\beta_1(1/TA_{it-1}) + \beta_2(\Delta REV_{it}/TA_{it-1}) + \beta_3(\Delta PPE_{it}/TA_{it-1})\} \quad Eq. 5.4$$

In this study, I use absolute abnormal accruals in examining the effect of RP transactions on earnings quality. The main objective of this study is to investigate the possibility of RP transactions being used opportunistically by managers or controlling shareholders to obtain earnings through accruals, regardless of whether the intention is to increase or decrease earnings. Therefore, I use the absolute of abnormal accrual in order to eliminate managers'

or controlling shareholders' intention to increase earnings (positive *DAC*) or decrease earnings (negative *DAC*).

5.4.1 Discretionary Accruals (*DAC*) – Modified Jones Model

Dechow et al. (1995) modified the Jones model when estimating *DAC* to eliminate the conjectured potential of error when discretion is exercised over revenues. They exercise the original components of the Jones model but introduce a modification to estimate *NDAC* during the event period. They adjust the model by excluding the change in receivables from the change in revenues during the event period. Consistent with Dechow et al. (1995), this *DAC* for *i* firm and time *t* is determined via the following equation:

$$\begin{aligned} DAC_{it}(\varepsilon_{it}) = & (TACC_{it}/TA_{it-1}) - \{\beta_1(1/TA_{it-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it})/TA_{it-1} \\ & + \beta_3(\Delta PPE_{it}/TA_{it-1})\} \end{aligned} \quad Eq. 5.5$$

where, ΔREC_{it} is net receivables for firm *i* in year *t* less net receivables in year *t-1*. Other variables are defined in Eq. 5.4. I use the prediction error (*DAC*) from Eq. 5.5 to test the hypothesis. According to previous research, control variables that represent firm characteristics are size, leverage, growth, performance and risk (Young, 1998); corporate governance characteristics like audit quality, board and audit committee independence are included in the model.

This study controls the cross-section differential of a firm's operating cycle via firm's growth. The selection of this control variable is consistent with prior studies, particularly in relation to RP transactions and discretionary accruals (Young et al., 1998; Munir and Mohd-

Saleh, 2010; Jian and Wong, 2010; Aharony et al., 2010; Chen et al. 2011). Some prior studies such as Gordon and Henry (2005), Peasnell, Pope, and Young (2005), and Kuan et al., (2010) use the different measures to control the firm's operating cycle. McNichols (2000) find that growth is significantly associated with discretionary accruals. Therefore, rapidly growing firms are expected to experience larger accruals, hence low earnings quality. This study also includes FSIZE and RISK to control undetermined size effect (Aharony et al., 2010; Liu & Lu, 2007) and operating performance (Christie & Zimmerman, 1994; Aharony et al., 2010). This study believes that the inclusion of these variables would sufficiently control the cross-sectional differential in the firm's operating cycle. The testing model is shown as:

$$\begin{aligned}
 DAC_{i,t} = & \beta_0 + \Sigma(\beta_{1h}RPTYPE_{i,t}) + \beta_2GROWTH_{i,t} + \beta_3FSIZE_{i,t} + \beta_4DEBT_{i,t} \\
 & + \beta_5BDSIZE_{i,t} + \beta_6BDIND_{i,t} + \beta_7ACIND_{i,t} + \beta_8AOPIN_{i,t} + \beta_9AUDFIRM_{i,t} \\
 & + \beta_{10}TENURE_{i,t} + \beta_{11}CSOWN_{i,t} + \beta_{12}CSTYPE_{i,t} + \beta_{13}MOWN_{i,t} + \beta_{14}RISK_{i,t} \\
 & + \beta_{15}\Sigma^3_{ij}Year_{i,t} + \alpha_{16}\Sigma^4_{ij}Industry_{i,t} + \alpha_{17}\Sigma^4_{ij}Country_{i,t} + \varepsilon_{i,t}
 \end{aligned} \tag{Eq. 5.6}$$

where,

DAC_{it} , is absolute discretionary accrual based on the Modified Jones Model (1995) and calculated as Eq. 5.5,

$RPTYPE_{it}$, represents one of the following vectors describing a magnitude or abnormal accrual of total RP transactions, RP complex, Simple, Loan, Δ RPT, Δ Complex, Δ Simple, and Δ Loan;

$GROWTH_{it}$, is the market value of the firm at the end of a year t divided by book value of the total assets,

$FSIZE_{it}$, is a natural logarithm of total assets,

$DEBT_{it}$, is a ratio of total debt over total assets,

$BFSIZE_{it}$, is a board size based on actual number of directors,

$BDIND_{it}$, is a proportion of independent non-executive directors to total board members,

$ACIND_{it}$, is a proportion of independent non-executive members to total members on the audit committee,

$AOPIN_{it}$, is an indicator variable equal to one if the auditor issued a clean audit opinion, and zero otherwise,

$AUDFIRM_{it}$, is an indicator variable equal to one if the firm is audited by the Big 4, and zero otherwise,

$TENURE_{it}$, is an actual tenure of auditor and client engagement,

$CSOWN_{it}$, is a percentage of ownership belonging to the controlling shareholder,

$CSTYPE_{it}$, is an indicator variable equal to one if the controlling shareholder is an individual or family group and zero otherwise,

$MOWN_{it}$, is a percentage of managerial ownership,

$RISK_{it}$, is an operating risk measured based on three-year earnings standard deviation,

$Year_{it}$, is a vector of year indicator variables 2008, 2009, and 2010,

$Industry_{it}$, is a vector of industry indicator variables based on the GICS industry classification, and

$Country_{it}$, is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand.

5.4.2 Performance Matched Discretionary Accruals (PMDAC) Model

I also use the PMDAC model by Kothari et al. (2005) to estimate discretionary accruals. Extending the Jones (1991) and Modified Jones models, *PMDAC* is raised due to the need to control the effect of current or the past year's return on assets on estimated *DAC* (Dechow, Kothari, & Watts, 1998; Kothari et al., 2005). The *PMDAC* model is a method for countering the likelihood of a spurious indication of *DAC* being extremely high in samples experiencing unusual previous performance as suggested by Dechow et al. (1995) and Guay et al. (1996). This method is guided by the modeling of earnings, cash flow accruals developed by Dechow et al. (1998). The cross-sectional *PMDAC* is calculated by including the lagged variable, returns on assets (*ROA*), as suggested by Kothari et al. (2005). I use the following equation to calculate the parameter of expected *PMDAC*:

$$\begin{aligned} TACC_{i,t}/TA_{i,t-1} = & \beta_0 + \beta_1(1/TA_{i,t-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it})/TA_{i,t-1} + \beta_3(PPE_{i,t}/TA_{i,t-1}) \\ & + \beta_4ROA_{i,t-1} + \varepsilon_{i,t} \end{aligned} \quad Eq. 5.7$$

where, *TACC* represents total accruals; *TA_{i,t-1}* is opening total assets, ΔREV_{it} is a change in net revenues for firm *i* in a year *t*, ΔREC_{it} is net receivables for firm *i* in year *t* less net receivables in year *t-1*, *PPE_{i,t}* is property plant and equipment for firm *i* in the year *t*, *ROA_{i,t-1}* is a ratio of net income before extraordinary items to total assets for firm *i* in the year *t-1*, and ε is the prediction errors. Then, consistent with the models developed by Jones (1991), Dechow et al. (1995) and Kothari et al. (2005), I estimate the *PMDAC* as the prediction errors (ε) from the following equation:

$$\begin{aligned} PMDAC_{i,t}(\varepsilon_{i,t}) = & TACC_{i,t}/TA_{i,t-1} - \{\beta_0 + \beta_1(1/TA_{i,t-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it})/TA_{i,t-1} \\ & + \beta_3(PPE_{i,t}/TA_{i,t-1}) + \beta_4ROA_{i,t-1}\} \end{aligned} \quad Eq. 5.8$$

A prediction error (*PMDAC*) that is obtained from the equation Eq. 5.8 is regressed to RP transactions and their classifications to examine the association between RP transactions and discretionary accruals. Consistent with Eq. 5.6, I include control variables that represent firm and governance characteristics. The equation to test the hypotheses is as follows:

$$\begin{aligned}
PMDAC_{i,t} = & \beta_0 + \Sigma(\beta_{1h}RPTYPE_{i,t}) + \beta_2GROWTH_{i,t} + \beta_3FSIZE_{i,t} + \beta_4DEBT_{i,t} \\
& + \beta_5BDSIZE_{i,t} + \beta_6BDIND_{i,t} + \beta_7ACIND_{i,t} + \beta_8AOPIN_{i,t} + \beta_9AUDFIRM_{i,t} \\
& + \beta_{10}TENURE_{i,t} + \beta_{11}CSOWN_{i,t} + \beta_{12}CSTYPE_{i,t} + \beta_{13}MOWN_{i,t} + \beta_{14}RISK_{i,t} \\
& + \beta_{15}\Sigma^3_{ij}Year_{i,t} + \beta_{16}\Sigma^4_{ij}Industry_{i,t} + \beta_{17}\Sigma^4_{ij}Country_{i,t} + \varepsilon_{i,t}
\end{aligned} \tag{Eq. 5.9}$$

where:

PMDAC_{it} is absolute discretionary accrual based on Kothari et al. (2005), calculated by Eq. 5.8,
RPTYPE_{it} represents one of the following vectors describing a magnitude or magnitude change of total RP transactions, Complex, Simple, Loan, Δ RPT, Δ RP complex, Δ RP simple, and Δ RP loan;
GROWTH_{it} is the market value of the firm at the end of year t divided by book value of total assets,
FSIZE_{it} is a natural logarithm of total assets,
DEBT_{it} is a ratio of total debt over total assets,
BFSIZE_{it} is a board size based on actual members of the board of directors,
BDIND_{it} is a proportion of independent non-executive directors to total board members,
ACIND_{it} is a proportion of independent non-executive members to total members on audit committee,
AOPIN_{it} is an indicator variable equal to one if the auditor issued a clean audit opinion, and zero otherwise,
AUDFIRM_{it} is an indicator variable equal to one if the firm is audited by the Big 4, and zero otherwise,
TENURE_{it} is an actual tenure of auditor and client engagement,
CSOWN_{it} is a percentage of ownership belonging to the controlling shareholder,
CSTYPE_{it} is an indicator variable equal to one if the controlling shareholder is an individual or family group and zero otherwise,
MOWN_{it} is a percentage of managerial ownership,
RISK_{it} is an operating risk measured based on three-year earnings standard deviation,
Year_{it} is a vector of year indicator variables 2008, 2009 and 2010,
Industry_{it} is a vector of industry indicator variables based on the GICS industry classification, and
Country_{it} is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand.

5.5 Firm Valuation

Investors and shareholders can use firm value or stock price to demonstrate their protest against companies engaged in RP transactions. In sum, RP transactions could have positive and negative effects on stock price or market valuation. However, most studies suggest RP transactions are abused by managers or controlling shareholders to expropriate wealth from

their firms. If the investors and shareholders perceive that RP transactions are not really for a company's needs, they can discount the stock price by selling or refusing to buy the shares. I develop and describe the designation of the models in the following sub-sections.

5.5.1 Tobin's Q

I examine the association between RP transactions and the firm's market performance as measured by Tobin's Q. Tobin's Q compares the market value of the firms to a replacement value of their assets. I calculate Tobin's Q using Dahya et al. (2008) which is suitable for a cross-country analysis. The equation is shown here:

$$\text{Tobin's } Q = (TA_{it} - BVE_{it} + MVE_{it})/BVE_{it} \quad \text{Eq. 5.10}$$

where, MVE_{it} is a market value of equity of firm i in year t as at three months (90 days) after the fiscal year-end; TA is total assets for firm i in a year t ; and BVE is book value of equity of firm i in year t . I use the following equation to test the hypotheses. Specifically, I execute the equation to test the effect of RP transactions on Tobin's Q, and this is followed by separate regressions for RP complex, RP simple and RP loan transactions. This model also includes control variables in the multivariate analysis to control firm and governance characteristics differential effects as well as audit quality, as discussed in section 5.6.3.

$$\begin{aligned} Q_{i,t} = & \beta_0 + \beta_1 \sum_{ij}^8 RPTYPE_{i,t} + \beta_2 GROWTH_{i,t} + \beta_3 FSIZE_{i,t} + \beta_4 DEBT_{i,t} + \beta_5 BDSIZE_{i,t} \\ & + \beta_6 BDIND_{i,t} + \beta_7 ACIND_{i,t} + \beta_8 AOPIN_{i,t} + \beta_9 AUDFIRM_{i,t} + \beta_{10} TENURE_{i,t} \\ & + \beta_{11} CSOWN_{i,t} + \beta_{12} CSTYPE_{i,t} + \beta_{13} MOWN_{i,t} + \beta_{14} RISK_{i,t} + \beta_{15} DAC_{i,t} \\ & + \beta_{16} \sum_{ij}^3 Year_{i,t} + \beta_{17} \sum_{ij}^4 Industry_{i,t} + \beta_{18} \sum_{ij}^4 Country_{i,t} + \varepsilon_{i,t} \end{aligned} \quad \text{Eq. 5.11}$$

where:

$Q_{i,t}$ is approximation of Tobin's Q from the Eq. 5.10

$RPTYPE_{it}$ represents one of the following vectors describing a magnitude or abnormal RP transaction, RP complex, RP simple, RP loan, ΔRP complex, ΔRP simple and ΔRP loan, scaled by the opening total assets.

$GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$;

$FSIZE_{it}$ is natural logarithm of total assets,

$DEBT_{it}$ is a ratio of total debt to total assets,

$BSIZE_{it}$ is a board size based on actual members of the board of directors,

$BDIND_{it}$ is a proportion of independent non-executive directors to total board members,

$ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee,

$AOPIN_{it}$ is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise,

$AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by the Big 4, and zero otherwise,

$TENURE_{it}$ is an actual tenure of auditor and client engagement,

$CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder,

$CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise,

$MOWN_{it}$ is a percentage of managerial ownership,

$RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation,

DAC_{it} is absolute discretionary accruals based on the Modified Jones Model (1995)

$Year_{it}$ is a vector of year indicator variables 2008, 2009 and 2010,

$Industry_{it}$ is a vector of industry indicator variables based on the GICS industry classification, and

$Country_{it}$ is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand.

5.5.2 Earnings-Market Valuation

The effect of RP transactions and its components on the market valuation are analyzed by regressing the market value of equity to the equity book value and net income. The market valuation model is frequently used throughout the accounting literature to test the value relevance of accounting information, but it is now only emerging in RP transaction research. Barth et al. (2001) and Beaver (2002) state that the design can determine what accounting numbers are reflected in firm value, in this case RP transactions. Also, the scope of the market value relevance differs from Tobin's Q model as the earnings-market valuation model is only analyzed for the value of the firm's equity. In contrast, the Tobin's Q model represents replacement costs of the firm's total assets that reflect total firm valuation or performance.

The fundamental argument is that a firm may be valued less than other firms due to risk. This higher risk implies lower valuations and higher returns to compensate for the risk (Kohlbeck & Mayhew, 2010). Thus, if the market participants perceive that RP transactions increase the likelihood of wealth expropriation, this is reflected by having a lower firm valuation. Therefore, I construct the testing model based on a market value of the equity model used by Ohlson (1995), Collins, Maydew, and Weiss (1997), Barth et al. (1998), Francis and Schipper (1999), Barth et al. (2001), Beaver (2002) and Ge et al. (2010):

$$MVE_{i,t} = \beta_0 + \beta_1 BVE_{i,t} + \beta_2 EARN_{i,t} + \varepsilon_{i,t} \quad \text{Eq. 5.12}$$

where, *MVE* is a market value of equity for firm *i* in year *t* as at three months (90 days) after the fiscal year-end, *BVE* is a book value of equity, *EARN* is a net income before extraordinary items, *i* denotes firms and *t* stands for year. Then, I form a regression equation, *Eq. 5.13* to examine the effect of RP transactions and their classifications on a firm's market valuation. I add and substitute the other value-relevant information with RP transactions or each type of RP transaction. This model also includes control variables that represent firm and governance characteristics differential effects as well as audit quality. The final model to test the hypotheses is as follows:

$$\begin{aligned} MVE_{i,t} = & \beta_0 + \beta_1 BVE_{i,t} + \beta_2 EARN_{i,t} + \beta_3 \sum_{ij}^8 RPTYPE_{i,t} + \beta_4 BVE_{i,t} * \sum_{ij}^8 RPTYPE_{i,t} \\ & + \beta_5 EARN_{i,t} * \sum_{ij}^8 RPTYPE_{i,t} + \beta_6 GROWTH_{i,t} + \beta_7 FSIZE_{i,t} + \beta_8 DEBT_{i,t} \\ & + \beta_9 BDSIZE_{i,t} + \beta_{10} BDIND_{i,t} + \beta_{11} ACIND_{i,t} + \beta_{12} AOPIN_{i,t} + \beta_{13} AUDFIRM_{i,t} \\ & + \beta_{14} TENURE_{i,t} + \beta_{15} CSOWN_{i,t} + \beta_{16} CSTYPE_{i,t} + \beta_{17} MOWN_{i,t} + \beta_{18} RISK_{i,t} \\ & + \beta_{19} DAC_{i,t} + \beta_{20} \sum_{ij}^3 Year_{i,t} + \beta_{21} \sum_{ij}^4 Industry_{i,t} + \beta_{22} \sum_{ij}^4 Country_{i,t} + \varepsilon_{i,t} \end{aligned} \quad \text{Eq. 5.13}$$

where:

MVE_{it} is three months after the fiscal year-end market value of common shareholder's equity, scaled by the beginning number of shares;
 BVE_{it} is year-end book value of common equity, scaled by the beginning number of shares;
 $EARN_{it}$ is year-end income before extraordinary, scaled by the beginning number of shares;
 $RPTYPE_{it}$ represents one of the following vectors describing a magnitude or magnitude change of total RP transactions, RP complex, RP simple, RP loan, ΔRPT , ΔRP complex, ΔRP simple and ΔRP loan, scaled by the beginning number of shares;
 $GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$;
 $FSIZE_{it}$ is natural logarithm of total assets,
 $DEBT_{it}$ is a ratio of total debt to total assets,
 $BSIZE_{it}$ is a board size based on actual members of the board of directors,
 $BDIND_{it}$ is a proportion of independent non-executive directors to total board members,
 $ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee,
 $AOPIN_{it}$ is an indicator variable equal to one if the auditor issued a clean audit opinion, and zero otherwise,
 $AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by the Big 4, and zero otherwise,
 $TENURE_{it}$ is an actual tenure of auditor and client engagement,
 $CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder,
 $CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise,
 $MOWN_{it}$ is a percentage of managerial ownership,
 $RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation,
 DAC_{it} is discretionary accruals based on the modified Jones model (1995)
 $Year_{it}$ is a vector of year indicator variables 2008, 2009 and 2010,
 $Industry_{it}$ is a vector of industry indicator variables based on the GICS industry classification, and
 $Country_{it}$ is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand.

5.5.3 Earnings Informativeness

My third measure is the earnings informativeness model. Earnings informativeness is based on the earnings and share return association. As mentioned in Section 5.5.2, the price level model is frequently used in the accounting literature to test the value relevance of accounting information, particularly in determining certain accounting numbers on firm value (Barth et al., 2001; Beaver, 2002; Ge et al., 2010). I construct a regression model based on Warfield et al. (1995) to test whether magnitude or abnormal RP transactions or types of its classifications reduce informativeness of earnings. Warfield et al. (1995) model has been used widely in various studies on accounting by Francis, Schipper, and Vincent (2005), and

Ahmed et al. (2006). However, Wang and Yuan (2012) is the only study that applies the model for RP transactions.

The effect of RP transactions will be assessed by the magnitude (slope coefficient) for RPTYPE*EPS, the interaction between RP transactions and earnings (Givoly, Hayn, & Natarajan, 2007). The interaction indicates that the presence of RP transactions would affect the usefulness of earnings information given in the financial reporting (Warfield et al., 1995; Wang & Yuan, 2012). A negative association between the interaction variable and share return shows that the presence of RP transactions reduces the informativeness of earnings and vice versa. In contrast, the main variable, RPTYPE captures a direct relationship between RP transactions and share return. The negative relationship indicates that the presence of RP transactions (magnitude/abnormal) is associated with lower share return without considering the impact of earnings. I substitute the interaction variable (RP transactions) with RP complex, RP simple or RP loan accordingly in separate regressions to investigate the effect of RP transaction types on earnings informativeness. This model consists of control variables that represent corporate governance and firm characteristics. I also include another firm's characteristics control variable, earnings change (ΔEPS). The model is as follows:

$$\begin{aligned}
 RET_{i,t} = & \beta_0 + \beta_1 \Delta EPS_{i,t} + \beta_2 EPS_{i,t} + \beta_3 \sum_{ij}^8 RPTYPE_{i,t} + \beta_4 EPS_{i,t} * \sum_{ij}^8 RPTYPE_{i,t} \\
 & + \beta_5 GROWTH_{i,t} + \beta_6 FSIZE_{i,t} + \beta_7 DEBT_{i,t} + \beta_8 BDSIZE_{i,t} + \beta_9 BDIND_{i,t} \\
 & + \beta_{10} ACIND_{i,t} + \beta_{11} AOPIN_{i,t} + \beta_{12} AUDFIRM_{i,t} + \beta_{13} TENURE_{i,t} \\
 & + \beta_{14} CSOWN_{i,t} + \beta_{15} CSTYPE_{i,t} + \beta_{16} MOWN_{i,t} + \beta_{17} RISK_{i,t} + \beta_{18} DAC_{i,t} \\
 & + \beta_{19} \sum_{ij}^3 Year_{i,t} + \beta_{20} \sum_{ij}^4 Industry_{i,t} + \beta_{21} \sum_{ij}^4 Country_{i,t} + \varepsilon_{i,t}
 \end{aligned} \tag{Eq. 5.14}$$

where:

RET_{it} is share return measured for twelve-months extending from nine months prior to the fiscal year through three months after the fiscal year-end calculated by natural logarithm share price of year t scaled to share price of year $t-1$;

ΔEPS_{it} is firm's i earnings before extraordinary items per share in year t minus earnings before extraordinary items per share in year $t-1$, scaled by the beginning share price;

EPS_{it} is earnings before extraordinary items per share, scaled by the beginning share price;

$RPTYPE$ represents one of the following vectors describing a magnitude or abnormal RP transactions, RP complex, RP simple, RP loan, ΔRPT , ΔRP complex, ΔRP simple and ΔRP loan, scaled by the beginning total assets.

$GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$;

$FSIZE_{it}$ is natural logarithm of total assets,

$DEBT_{it}$ is a ratio of total debt to total assets,

$BSIZE_{it}$ is a board size based on actual members of the board of directors,

$BDIND_{it}$ is a proportion of independent non-executive directors to total board members,

$ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee,

$AOPIN_{it}$ is an indicator variable equal to one if the auditor issued a clean audit opinion, and zero otherwise,

$AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by the Big 4, and zero otherwise,

$TENURE_{it}$ is an actual tenure of auditor and client engagement,

$CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder,

$CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise,

$MOWN_{it}$ is a percentage of managerial ownership,

$RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation,

DAC_{it} is absolute discretionary accruals based on Modified Jones Model (1995)

$Year_{it}$ is a vector of year indicator variables 2008, 2009 and 2010,

$Industry_{it}$ is a vector of industry indicator variables based on the GICS industry classification, and

$Country_{it}$ is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand.

5.6 Operationalization of Variables

5.6.1 Dependent Variables

In this study, I use different dependent variables in every model. To represent discretionary accruals, I use DAC and $PMDAC$, i.e. the prediction errors from non-discretionary accruals expectation models. I also use Tobin's Q , market value of equity (MVE) and annual share returns (RET) in the firm valuation models. The detailed measurements of these variables have been discussed in subsections 5.4.1, 5.4.2, 5.5.1, 5.5.2, and 5.5.3, respectively.

5.6.2 *Independent Variable*

The main independent variable of this study is RP transactions and types of RP transactions, these being RP complex, RP simple and RP loan. I measure RP transactions and types of RP transactions via two different measurements. The first measure is a magnitude of the transactions in US\$ dollars. I determine the magnitude of RP transactions as an aggregate amount of all types of RP transactions that is reported in the firm's financial statement. The detail types of RP transactions include sales and purchases of goods, services and assets, rental and leases, consultation and administrative services, loan from or to related parties and others. While I determine the magnitude of RP complex and RP loan based on the aggregate amount of RP transactions that have been classified into these two categories. The detail classification of those types of RP transactions is shown in Figure 1. The magnitude of RP transactions and their types are scaled by the opening total assets for each year except in the market valuation model, which is scaled by the opening number of shares outstanding. A few studies use the magnitude of RP transactions (Cheung et al., 2006; Jian & Wong, 2010; Munir & Gul, 2010) while others such as Dahya et al. (2008), Kohlbeck and Mayhew (2010), and Ge et al. (2010) use dummies to represent firm disclosure or non-disclosure of RP transactions.

The second measure is abnormal RP transactions, RP complex, RP simple or RP loan, which is based on the magnitude change of such transaction in the event period. It is calculated with US\$ dollars for the RP transactions in a year t minus the US\$ dollar amount of the RP transactions in a year $t-1$ ($RPTYPE_{i,t} - RPTYPE_{i,t-1}$). Similar to the magnitude, the abnormal is scaled by the opening total assets of each year except in the market valuation model,

which is scaled by the opening number of shares outstanding. Positive abnormal RP transactions indicate an increase in US\$ dollar amount of the transactions or otherwise; the negative signs depict the decrease in such a transaction. The findings will strengthen Aharony et al. (2010) who also use the abnormal to measure RP transactions in real-based earnings management's studies.

I will expand on the Kohlbeck and Mayhew (2010) and Dahya et al. (2008) studies by using continuous measurements rather than a discrete parameter to measure RP transactions. Basically, a continuous set of possible values would allow for a more exact and precise measurement. This measurement is more informative and more representative in predicting the potential corrupt nature of RP transactions, particularly the link between RP transactions and discretionary accruals. Furthermore the disclosure requirements of the standards and listing requirements in East Asian economies vary, and this forces listed firms to disclose RP transactions differently. In practice, some firms may disclose RP transactions in their notes to accounts, director's reports or corporate governance section not in the main financial statement. Therefore, I believe that the use of magnitude and abnormal RP transactions is more precise in determining the effect of the transaction in this cross-country analysis.

RP transactions are recognized as ensuring the effectiveness of a firm's daily operations. It is relatively difficult for investors or shareholders to evaluate potentially illegal transactions by referring to the firm's disclosure or non-disclosure of the transaction. Based on the magnitude and abnormal RP transactions and types of RP transactions, I predict a positive association between RP transactions and *DAC*, and *PMDAC*. In contrast, the relationship

between RP transactions and firm market performance (Q), market valuation (MVE) and share returns (RET) is expected to be negative.

5.6.3 *Control Variables*

There are other factors that may occur when firms practice RP transactions. It is possible that these factors may have affected the results. As reviewed in Chapter 3, the determinants such as corporate governance practices, external monitoring function, and managerial or controlling shareholders due to concentrated ownership may affect the decision to deal with related parties. Other confounding factors may include variables that are correlated with firm characteristics like size, leverage, growth, and risk. These attributes have been identified as affecting firm valuation and firm involvement in accrual management. Including these variables ensures the effect of RP transactions on discretionary accruals, and firm valuation is not spurious due to the missing variables. These factors need to be addressed in more detail.

I develop testing models that incorporate such variables to control cross-sectional differential effects of firm, corporate governance, and audit quality characteristics. The variables represent firm characteristics including size ($FSIZE$), leverage ($DEBT$), firm growth ($GROWTH$), operating risk ($RISK$), and earnings quality (DAC)⁴⁸. Three variables represent audit qualities, audit opinion ($AOPIN$), audit firm size ($AUDFIRM$), and auditor tenure ($TENURE$). I also include six variables representing corporate governance: board size ($BSIZE$), board independence ($BIND$), audit committee independence ($ACIND$), controlling shareholder (CS), type of controlling shareholders ($CSTYPE$), and managerial ownership

⁴⁸ Control variable of earnings quality (DAC) is only included in the firm valuation models.

(*MOWN*). I include an additional control variable in the earnings informativeness model, *ΔEPS* (see sub-section 5.5.3). In the earnings-market valuation model, I include interactions between RP transactions and *BVE*, and *EARN* (discussed in sub-section 5.5.2). Additionally, I include control variables for differences of year (*YEAR*), industry (*Industry*), and country (*Country*). The inclusion of these three control variables is consistent with the Mitton (2002) procedure. Evidence from other studies is used as the basis for selecting these control variables. The next sub-section discusses the measurement of these control variables.

In brief, I include the major traditional business characteristics variables such as growth (*GROWTH*), leverage (*DEBT*), and firm size (*FSIZE*). I introduce firm growth (*GROWTH*) to control for cross-sectional differences in a firm's growth across our sample firms. In the discretionary accrual models, *GROWTH* is measured based on the market value of a firm at the end of the year divided by book value of the total assets. Meanwhile in the firm valuation models, *GROWTH* is measured by the previous year's growth which is calculated based on the market value of equity for a year $t-1$ divided by book value of total assets for a year $t-1$ ⁴⁹. Collins and Kothari (1989) show earnings informativeness is positively associated with a firm's growth. Dechow et al. (1995) and Kasznik (1999) indicate that firm growth tends to have a positive relationship with *DAC*. Thus, this study predicts that *GROWTH* would be positively associated with earnings management (*DAC* and *PMDAC*) as well as firm valuations (*Q*, *MVE* and *RET*). Including these three variables in all regression

⁴⁹ I also use an alternative measurement for *GROWTH* in the firm valuation model, this being sales growth which is measured according to the change in sales in the period scaled by total assets. With this measurement I adjusted R^2 so it became smaller in all models. The results for the earnings informativeness (*RET*) model and earnings-market valuation (*MVE*) model are consistent. However, the results for the Tobin's Q models are slightly mixed, particularly for abnormal measurement.

analyses is consistent with studies showing the relationship between magnitude of share return, earnings informativeness and discretionary accruals.

The *DEBT* is measured by total debt over total assets, and the *FSIZE* is measured by the natural logarithm of the book value of year-end total assets. The inclusion of these variables is vital to control for cross-sectional differences between our sample firms in financial leverage, size, and growth, respectively. Prior research reveals *DAC* is positively associated with leverage since high leverage firms try to increase their reported earnings. Highly leveraged firms are more likely to be involved in more contractual negotiations with certain related parties such as workers or lenders. These firms may have incentives to reduce earnings for particular reasons such as concessions (Becker, DeFond, Jiambalvo, & Subramanyam, 1998; DeAngelo & DeAngelo, 1991).

Myers (2001) finds larger financially leveraged firms may monitor their managers and controlling shareholders, and this can reduce agency costs, and improve firm performance. Therefore, I predict a negative association between leverage (*DEBT*) and *DAC*, and *PMDAC*. In contrast, Dhaliwal, Lee, and Fargher (1991) find that earnings response coefficient (*ERC*) for high leverage firms is less than low leverage firms. Consequently, firm valuation and informativeness of earnings are related to a firm's total leverage. Ahmed et al. (2006) also confirm firm leverage has a negative association with share returns. Therefore, I expect *DEBT* will be negatively linked to firm market performance (*Q*), market valuation and share returns.

The inclusion of both firm size and risk is motivated by political process theory (Watts & Zimmerman, 1986). Large firms, by nature, have more political exposure than smaller ones. For example, a government may give more attention to larger companies, specifically for tax purposes (Watts & Zimmerman, 1986). Corporations may use accruals to decrease income in order to reduce the probability of adverse political exposure (Cahan, 1992). Williamson (1967) suggests that larger firms could be less efficient senior managers' control of strategic and operational activities is weaker. Freeman (1987) finds earnings response coefficient (*ERC*) is negatively related to firm size, while Chaney and Jeter (1992) report that the *ERC* increases with firm size. The inclusion of *SIZE* in the multivariate models, predicted to have a negative relationship to *DAC* and *PMDAC*, is also negatively associated with firm market performance, market valuation and share returns.

RISK is introduced to represent the firm operating risk, which is measured by a natural logarithm of a firm's standard deviation of earnings for three accounting periods. This control variable is important to control firms' operating risk differences within the sample because this study uses cross-country data. According to Zmijewski and Hagerman (1981), high-risk firms possess greater incentives to exploit accounting information. Managers or controlling shareholders of high-risk firms are expected to have greater incentives to manipulate their earnings (Sánchez-Ballesta & García-Meca, 2007). I therefore predict that *RISK* will be positively associated with *DAC* and *PMDAC*, and otherwise it is expected negatively to relate to a firm's market performance, valuation, and earnings informativeness.

Audit opinion (*AOPIN*), size of audit firm (*AUDFIRM*), and tenure auditor-client engagement (*TENURE*) are part of this thesis, to represent audit quality. The *AOPIN* is measured using a dummy variable, which the value of 1 representing a firm issued with an unqualified audit opinion (clean audit report), otherwise 0 for a firm issued with a qualified audit opinion, specifically, due to RP transactions (including qualified, adverse or disclaimer). An independent auditor directly affects the quality of the information disclosed by businesses, where the auditors can issue a qualified audit opinion, if required. Audit reports without qualified opinion indicate a stable financial position, less serious tunneling activities; hence they reduce potential of illegal earnings management (Gao & Kling, 2008). The reliability of audit opinion for a large firm is much higher than for small businesses.

The *AUDFIRM* refers to size of audit firms either large (Big-4) or small (non-Big-4) firms. It is measured by a dummy equal to 1 for firms audited by auditors from Big-4 firms, and 0 otherwise. Audit quality literature suggests that large accounting firms (Big-4) are more effective in limiting excessive accrual manipulation, including RP transactions (Gao & Kling, 2008). Therefore, firms without a Big-4 audit firm are expected to have more aggressive accruals manipulation, and high discretionary accruals. Teoh and Wong (1993) and Gul, Lynn, and Tsui (2002) emphasize that the earnings response coefficients of Big-4 audit firms' clients are significantly higher than those of non-Big-audit firms' clients. The link is based on the arguments that earnings quality is positively related to the relationship between reported earnings and market returns. Earnings have a greater effect on investors' valuation of a business when the numbers are perceived as more accurately reflecting true economic value and a Big-4 audit firm is associated with better quality audits that show

evidence of greater performance. Gul et al. (2002) suggest an informativeness of earnings for firms, in which the managers have a lower ownership, should be higher for Big 4 -audit firms than for non-Big-4 audit firms' clients. Therefore, *AUDFIRM* is expected to be negatively associated with discretionary accruals but positively associated with firm valuations.

I also control for *TENURE*, which refers to the tenure of auditor-client relationship that is measured based on the actual number of the auditor-client engagement period. Studies cited in this thesis conclude that earnings quality and perceptions of earnings quality increase when audit firm tenure also increases (Johnson, Khurana, & Reynolds, 2002; Mansi, Maxwell, & Miller, 2004; Myers, Myers, & Omer, 2003). Johnson et al. (2002) and Myers et al. (2003) provide evidence suggesting that tenure could restrain discretionary accruals. Their observations indicate that managers interfering with accruals is obvious when in a shorter and medium auditor-client relationship, but not in a longer one. Geiger and Raghunandan (2002) conclude that audit failures are more likely to occur at the beginning of the auditor-client relationship. Longer tenure allows the auditor to learn more about the client and obtain a more detailed understanding of its business processes. The auditors also gain experience that could result in a more effective audit system (Crabtree, Brandon, and Maher (2006). Choi and Doogar (2005) also demonstrate that longer auditor tenure reduces the likelihood of the firm received going-concern qualification⁵⁰ from the auditor and increases the reliability of financial reporting.

⁵⁰ One type of audit opinion issued by the auditors due to the audited firm has a going-concern problem.

In contrast, human behavioural factors may influence the auditor-client relationship. Longer auditor tenure has been criticized for developing the closed relationship between auditor and clients. In fact, Choi and Doogar (2005), and Davis, Soo, and Trompeter (2003) suggest that longer auditor tenure impairs auditor independence and objectivity because it can lead to an overly strong loyalty to the clients. Flint (1988) argues that if the auditor is involved in a private relationship with a client, the auditor's independence, mental judgement, attitude and opinion are compromised, which leads to audit quality decline and increases the risk of audit failure. Consequently, the auditor may fail to maintain professional rigor and start to make unjustified assumptions instead of objective evaluations. The main concern raised by Gordon et al. (2007) is that firms found manipulating their earnings through RP transactions intend to appoint an auditor who they know. Thus, tenure auditor-client could raise two possible effects - either efficient audit or conflict of interest. Therefore, I do not predict what direction the relationship between *TENURE* and *DAC*, *PMDAC*, *Q*, *MVE* and *RET* will take.

Control variables that represent corporate governance characteristics are essential to this study. Previous studies suggest that board size (*BSIZE*), board independence (*BIND*), audit committee independence (*ACIND*), controlling shareholder ownership (*CSOWN*), type of controlling shareholders (*CSTYPE*), and managerial ownership (*MOWN*) are associated with earnings management and how they affect firm valuation. It has been demonstrated that *BSIZE* potential is measured based on actual numbers of a board of directors. One study on corporate governance suggests that small boards are more effective than larger ones in monitoring company business. Pierce and Zahra (1992) suggest that there is a relationship

between firm performance and board size. Small boards generally communicate and coordinate their work well, and less incidence of a severe free-rider problem, i.e. the directors who do not play their role effectively (Ahmed et al., 2006; Yermack, 1996).

Large boards of directors risk having ineffective coordination and confused decision-making, particularly if they are controlled by a domineering Chief Executive Officer (Jensen, 1993). Here it would become difficult for independent directors to express their ideas and opinions, and influence the effectiveness of decision-making and control. However, evidence also shows that risk of firm failure is higher for a firm with a smaller board (Chaganti, Mahajan, & Sharma, 1985). Pierce and Zahra (1992) emphasize that larger boards have the advantage of more information and expertise. Dalton, Daily, Johnson, and Ellstrand (1999) analyze 20,620 firms in 27 studies, and found that larger boards have a positive relationship with firm performance. The larger board has more external links and the ability to extract critical resources, expertise, and experience in running a business.

Board independence (*BIND*) is an essential ingredient for effective governance. It is measured as a proportion of independent non-executive directors to total board members. Without independent monitoring by outside directors, boards dominated by managers or controlling shareholders may transfer wealth to themselves at the expense of shareholders (Beasley, 1996; Fama, 1980). The appointment of independent non-executive directors can reduce agency conflict and increase firm performance through better monitoring of the board process (Cravens & Wallace, 2001). Some studies have proven the effectiveness of independent outside directors does improve a firm's performance (Dalton et al., 1999) and is

positively related to abnormal stock return (Rosentein & Wyatt, 1990). Klein (2002) finding support Beasley (1996) in that outside directors (independent non-executive directors) can limit a manager's manipulation of company earnings.

Independent non-executive directors should be able to identify misappropriation activities, including accrual-based earnings management involving RP transactions. They must have expertise in financial reporting and experience of having held senior management positions elsewhere (Peasnell, Pope, & Young, 2000). However, the independent non-executive director's role in monitoring function of the board may lack real independence, due to experience, insufficient time and supply of information, as well as the nature of his/her personal relationships (Gilson & Kraakman, 1991). In addition, the presence of controlling shareholders on the board may affect their ability to act independently. Thus, I predict a negative association between *BIND* and discretionary accruals to occur but a positive one with firm valuations.

Audit committee independence (*ACIND*) is scaled as a proportion of independent non-executive members to total membership of the audit committee. A number of studies have found a relationship between *ACIND* and financial reporting practices. Overall, they suggest that *ACIND* is effective in controlling accrual management practices. For example, Beasley et al. (2000) find that the *ACIND* reduces the likelihood of fraud appearing in financial statements. Elsewhere, Carcello and Neal (2000) state that distressed firms with the *ACIND* are more likely to be issued with an auditor's going-concern qualification. Klein (2002) shows *ACIND* has a negative relationship with earnings management.

Consequently, the creation of the *ACIND* is expected to increase investor confidence on the quality of current and future financial information. Indeed, Wild (1996) finds that the earnings of firms, which formed the *ACIND* between 1966 and 1980, are significantly more informative to market participants than before. This finding is consistent with the notion that the presence of the *ACIND* in the governance structure improves shareholders' trust in reported earnings quality. Brick and Chidambaran (2010) emphasize that *ACIND* may represent increased monitoring by the board and can affect the firm value. Black and Kim (2012) suggest that *ACIND* can positively affect business market value and its performance in Asian markets. They use small firms in South Korea and find evidence demonstrating that firm value increases. Thus, I predict that *ACIND* will be negatively associated with discretionary accruals, and positively related to a firm's market valuation. Nevertheless, there is also possibility that the *ACIND* may not be able to play their role effectively, particularly in the presence of controlling shareholders.

The next three control variables are related to the ownership structure, which is owned and shaped by managers or controlling shareholders. *CSOWN* is scaled based on a proportion of common shares held by controlling shareholders over total outstanding common shares (percentage of controlling shareholder ownership). Gomes (2000) argues that controlling shareholders do have a commitment to safeguarding the interests of minority shareholders. However, the risk of controlling shareholders expropriating wealth dominates other studies (see Gordon et al., 2004; Kohlbeck & Mayhew, 2010). Controlling shareholders have the authority to control a firm through having more voting rights, and therefore the advantage in using corporate resources for their own gain (Johnson et al., 2000; Shleifer & Vishny, 1997).

The presence of controlling shareholders substantially increases the likelihood of wealth expropriation (Aharony et al., 2010; Chen et al., 2011). As discussed earlier in Chapter 2, the controlling shareholders can manipulate earnings by structuring real operating transactions, discretionary accruals or various combinations of them in ambiguous ways. The agency problem is also likely to be more severe in firms where controlling shareholders are part of the management team. Thus, I predict that *CSOWN* has a positive association with *DAC* and *PMDAC*, but negatively related to *Q*, *MVE*, and *RET*.

Controlling shareholders can be individuals, family group, corporation, foreign investors, or government (*CSTYPE*). *CSTYPE* is an indicator variable equal to one if the controlling shareholder is an individual or family group and zero otherwise, if the controlling shareholder is a corporation or government. Bertrand et al. (2008) and Wiwattanakantang (2001) finds a significant positive association between family size and family involvement in the ownership and control of such businesses. However, the aligned association is reversed when the controlling shareholders increase their share ownership exceeds 25%, which consistent with the entrenchment hypothesis. A business founder's offspring often play a central role in both ownership and board membership after the death of the founder and family-run groups over time increase the potential of tunneling resources to somewhere else. Munir and Mohd-Saleh (2009) conclude that family-controlled firms increase the potential of earnings management. Bertrand et al. (2002), Wiwattanakantang (2001) and Munir and Gul (2010) demonstrate that family controlled firms have less market valuation suggesting investors may perceive the controlling shareholders behaving opportunistically. The

CSTYPE is predicted to have a negative association with *MVE*, *Q*, and *RET* but will be positively related to *DAC* and *PMDAC*.

Managerial ownership (*MOWN*) is scaled based on a proportion of common shares held by managers over total outstanding shares (percentage of managerial ownership). According to agency theory, managerial ownership could reduce agency conflict arising from the separation of stock ownership and control between managers and stockholders. The shareholders and managers' interests start to converge when managerial ownership increases. Demsetz and Lehn (1985) support agency theory by proving there is a positive relationship between managerial ownership and firm performance. In another study, Warfield et al. (1995) it is found that the potential of earnings management falls when managerial ownership increases. However, the managers will entrench when their increment in the managerial share ownership excessive certain percentage. The managers will favor maximizing their personal benefits than minority shareholders, which is consistent with the entrenchment hypothesis (Morck et al., 1988). Thus, I do not predict in what direction the link between discretionary accruals and firm valuations will go, because the relationships will depend on the potential of alignment or entrenchment, which are dominant.

A variable to control cross-sectional firm differences in changes of earnings (ΔEPS) is included but in the earnings informativeness model only. ΔEPS is measured as a firm's earnings before extraordinary items per share in the year t minus earnings before extraordinary items per share in the year $t-1$. Lang and Lundholm (1996) and Wang and Yuan (2012) demonstrate that larger changes in earnings (ΔEPS) reduce the accuracy of an

earnings forecast. Chen, Chen, and Su (2001), Francis et al. (2005) and Wang and Yuan (2012) find stock returns are consistently positive and significantly associated with the level and change in earnings (ΔEPS). Thus, I predict a direction of ΔEPS in the earnings informativeness model is aligning with share returns (RET). I also include DAC in those three firm valuation models as representing a cross-differential in earnings quality. DAC is absolute discretionary accruals based on the modified Jones model (Dechow et al., 1995). Evidence shows that discretionary accruals are linked to firm performance (Gaioa & Raposo, 2011). Thus, I do not predict in which direction the DAC will go because it depends on managers' or controlling shareholders' intention to increase or decrease earnings.

I include almost same control variables in the earnings quality models and firm valuation models, particularly in Tobin's Q model. Research in accounting is underlying by multiple theories, particularly in a relationship between accounting numbers or characteristics (including operating and market performance, and reporting quality) and corporate governance matters. Basically, discretionary accruals that measure earnings quality have a substantial association with certain firm's characteristics, including growth, leverage and firm size (Jones, 1995; Dechow et al. 1995). However, there are many prior studies emphasize that corporate governance characteristics (internal and external) play major role in managers or controlling shareholders' involvement in earnings management activity (Peasnell et al., 2005). Peasnell et al. (2005) suggest that board monitoring contribute to the integrity of financial statement, which reduce earnings management. The argument is consistent with Fama and Jensen (1983) that board of directors is widely believed to play an important role in corporate governance, mainly in monitoring top management.

Table 5.3
Operational Definitions and Measurements of variables

Variable	Description
<i>DAC</i>	Absolute discretionary accrual that is calculated according to modified Jones model (1995).
<i>PMDAC</i>	Absolute performance matched discretionary accrual is calculated based on Kothari model (2005).
<i>Q</i>	Q is an approximation of Tobin's Q from the Eq. 10.
<i>MVE</i>	Market value of common shareholder's equity as at three months (90 days) after the fiscal year-end scaled by the beginning number of shares outstanding.
<i>SRETED</i>	A share return measured for twelve-months extending from nine months prior to the fiscal year through three months after the fiscal year-end. It is calculated by natural logarithm of share price of year <i>t</i> /share price of year <i>t-1</i> .
<i>EPS</i>	Earnings before extraordinary items per share; scaled by the opening share price.
<i>ΔEPS</i>	Firm's earnings before extraordinary items per share in year <i>t</i> minus earnings before extraordinary items per share in year <i>t-1</i> ; and scaled by the opening share price.
<i>EARN</i>	Year-end income before extraordinary divided by the beginning period of book value of common equity.
<i>BE</i>	Year-end book value of common equity divided by the beginning period of book value of common equity.
<i>RPTYPE</i>	Represent one of the following vectors describing magnitude type of RP Transactions (RPT, RP complex, RP simple, or RP loan) or abnormal types of RP Transactions (ΔRPT, ΔRP complex, ΔRP simple or ΔRP loan). The magnitude and abnormal are scaled by the beginning total assets or the beginning book value of equity.
<i>GROWTH</i>	A market value of the firm at the end of year <i>t</i> divided by book value of the total assets (for discretionary accrual models) or market value of the firm at the end of year <i>t-1</i> divided by the ending book value of the total assets at <i>t-1</i> (previous year's growth – for firm valuation models)
<i>FSIZE</i>	Natural logarithm of firm's total assets.
<i>DEBT</i>	A ratio of total debt to total assets.
<i>AOPIN</i>	An indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise.
<i>AFIRM</i>	An indicator variable equal to one if the firm is audited by Big 4, and zero otherwise.
<i>TENURE</i>	An actual number of year auditor-client engagements for audit services.
<i>BSIZE</i>	A board of director size that is represented by an actual number of members on the boards.
<i>BDIND</i>	A proportion of independent non-executive directors to total board members.
<i>ACIND</i>	A proportion of independent non-executive members to total members of the audit committee.
<i>CSOWN</i>	A percentage of ownership belongs to the controlling shareholder that is a percentage of ownership held by the controlling shareholders over the total number of outstanding shares.
<i>CSTYPE</i>	An indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise.
<i>MOWN</i>	A percentage of managerial equity ownership that is a percentage of ownership held by the managerial over the total number of outstanding shares.
<i>RISK</i>	A firm's operating risk that is calculated by natural logarithm of three years earnings standard deviation.
<i>Year</i>	A vector of year indicator variables 2008, 2009, and 2010. Dummy variable coded 1 if represent the specific year, 0 otherwise.
<i>Industry</i>	A vector of industry indicator variables based on the GICS industry classification. Dummy variable coded 1 if represent the specific industry, 0 otherwise.
<i>Country</i>	A vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand. Dummy variable coded 1 if represent the specific country, 0 otherwise.

Similarly, many corporate governance studies show relationships between governance characteristics and firm performance (Tobin's Q), value and share return (Rosentein & Wyatt, 1990; Dalton et al., 1999; Brick & Chidambaran, 2010). For example, managerial equity ownership (Warfield et al. 1995), board composition among outside directors and board size (Ahmed et al. 2006) and many others have been proven affecting firm's market performance and valuation. The presence of external monitoring in representing audit quality also play a significant role in monitoring earnings management and increase firm's valuation (Gul et al., 2002; Gao & Kling, 2008). Prior studies also emphasize that Tobin's Q has a significant association with certain firms' characteristics such as earnings quality, operating performance, growth, leverage, age and firm's size (Dahya et al. 2008; Lei and Song, 2011).

This study control firm's cross-sectional differential in corporate governance practices that have been proven associated with earnings quality and firm performance. The detail relationship between the selected corporate governance characteristics and discretionary accruals and firm performance has been discussed at earlier stage of this section. Based on the above arguments, I employ the same control variables in both earnings quality models (DAC & PMDAC) and Tobin's Q model. Nevertheless, I also include DAC in Tobin's Q model to control cross-sectional differential effect of earnings quality among firms (Munir & Gul, 2010). The inclusion of this control variable is substantial to differentiate earnings quality (DAC & PMDAC) and Tobin's Q models employed by this study. Even, this study may not include specific determinant used in prior studies such as CEO duality in DAC models and firm's age in Tobin's Q model (Dahya et al. 2008; Kohlbeck & Mayhew 2010), I

believe that the selected control variables could comprehensively substitute the omitted variables.

I also include dummy variables for *Year*, *Industry* and *Country* to control the differential effects of time, industry types and country respectively (Mitton, 2002). *Year* is a vector of year indicator variables 2008, 2009, and 2010. *Industry* is a vector of industry indicator variables based on the GICS industry classification, and *Country* is a vector of country indicator variables, i.e. Hong Kong, Malaysia, Singapore, and Thailand. Table 5.3 summarizes the operational definitions and measurements of the variables.

5.7 Summary and Conclusion

This chapter described the research design used in this thesis. The sample selection was chosen from listed firms in Hong Kong, Malaysia, Singapore, and Thailand. The final sample consisted of 423 firms with a total of 1269 observations. This sample represents about one-third of the listed firms from each country, which the annual reports being available for 2007-2010, and financial statements for 2006-2002. This study uses stratified random sampling to ensure the sample is a balance of large and small firms. These firms' financial data was retrieved from OSIRIS database. Most of the data use in this study is non-financial, consisting of RP transactions, corporate governance structure, and audit quality characteristics. These and archival information were collected by hand from the annual reports.

This chapter also describes the research methodology in two parts. The first part reviewed and developed models to examine the association between RP transactions on discretionary accruals, *DAC* and *PMDAC*. The *DAC* model is based on the modified Jones model (Dechow et al., 1995), and the *PMDAC* model is based on modified Jones model (Dechow et al., 1995) and performance matched model (Kothari et al., 2005). The next part described the development of three methodologies that will investigate the effect of RP transactions on firm valuations via market performance (Tobin's *Q*), earnings-market valuation (*MVE*), and earnings informativeness (*RET*). The first part of this market valuation describes the use of Tobin's *Q* model to examine the effect of RP transactions on firm performance. Then, the earnings-market valuation model is based on Ohlson (1995), Barth et al. (1998), Barth et al. (2001), and Beaver (2002). The final part discusses the development of the earnings informativeness model, which is based on Warfield et al. (1995). These models are regressed using pooled data analysis.

The final section of this chapter described the operationalization of the variables employed in these models. This study measures RP transactions via two different measures, magnitude and abnormal RP transactions. This section also discussed the inclusion of control variables based on previous studies; these variables will affect the dependent variables in these equation models. This study uses five variables to control cross-section differences in firm characteristics: leverage (*DEBT*), growth (*GROWTH*), size (*FSIZE*), operating risk (*RISK*), and discretionary accrual (*DAC*). Furthermore, board size (*BSIZE*), board independence (*BIND*), audit committee independence (*ACIND*), controlling shareholder's ownership (*CSOWN*), controlling shareholder types (*CSTYPE*), and managerial ownership (*MOWN*)

represent cross-sectional differences in corporate governance practice. Another three variables included were audit opinion (*AOPIN*), audit firm type (*AUDFIRM*), and audit tenure (*TENURE*) as attributes of audit quality.

Chapter 6

RP Transactions and Discretionary Accruals

6.1 Introduction

This chapter discusses the results of this study, in terms of presenting descriptive statistics to summarize the data concerning RP transactions. The chapter also presents a descriptive statistical analysis of dependent variables (*DAC* and *PMDAC*), and control variables. The independent variables are examined for their impact on both proxies of earnings quality, *DAC* and *PMDAC*. The multi-country analysis relies on the dataset of firms listed on the stock exchanges in Hong Kong, Malaysia, Singapore, and Thailand. Although managers or controlling shareholders have an opportunity to structure legally operating RP transactions, accruals are more acceptable because they can be manipulated. Since managers have to make appropriate disclosures of any changes in accounting methods as required by extant accounting standards, by nature, accounting methodology changes are more visible than accruals to users. Thus, this study predicts firms engaged in RP transactions will have higher discretionary accruals.

This chapter is organized as follows. Section 6.2 discusses the descriptive, correlation, multicollinearity and heteroskedasticity themes. Section 6.3 discusses the *DAC* multivariate results while the *PMDAC* multivariate results are outlined in Section 6.4. Section 6.5 discusses and interprets the results, and Section 6.6 provides the robustness check. Finally Section 6.7 concludes the chapter with a summary of the main points covered.

6.2. Descriptive Analysis

Table 6.1 reports the descriptive statistics for RP transactions and their classifications. RP transactions, RP complex, RP simple, and RP loan are scaled using the opening total assets. This sample is obtained from four different countries, thus, it is expected to have normality problem with the variables due to the outliers. Therefore, the data is winsorised to the point equivalent to the top and bottom at 1% level of the ranked variables. The skewness of RP transactions fell from 9.849 to 3.833, and the kurtosis decreased substantially from 116.587 to 19.950. A skewness of RP complex decreased from 10.613 to 4.107, and kurtosis also fell from 129.775 to 21.364. The winsorising procedure does not fully eliminate the outliers, but it will at least limit the effects.

Table 6.1 shows RP transactions have a mean (median) value of 0.097 (0.010) with a standard deviation of 0.219. RP complex has a mean (median) value of 0.057 (0.000) with standard deviation of 0.167. The mean (median) of RP simple is 0.033 (0.003), while the mean of RP loan is 0.010 (0.00) with a smaller standard deviation. These statistics indicate that on average, total magnitude of RP transactions in our sample is close to 10 percent of the beginning total assets. The major component of RP transactions is RP complex, which represents approximately 6 percent of the beginning total assets. RP simple is about 3.3 percent of the beginning total assets, and RP loan is only about 1 percent.

Table 6.1 also shows abnormal RP transactions (*ARPT*) have a positive mean (median) that is 0.010 (0.000) with small value of standard deviation, 0.109. The mean (median) of abnormal RP complex is 0.005 (0.000) and abnormal RP simple is 0.006 (0.000). The

positive mean (median) of abnormal RP transactions and its classification indicate the magnitude of RP transactions increased in our sample over the three-year period and for all types of classifications. On average, a magnitude of RP transactions increases 1 percent of the beginning total assets. Magnitudes of RP complex, RP simple and RP loan increased 0.5 percent, 0.6 percent, and 0.3 percent of the beginning total assets, respectively. The highest standard deviation is 0.219, suggesting that the data is not widely dispersed.

Table 6.1
Descriptive statistics of RP Transactions

n=1,195	Mean	Median	Std. Dev.	25th Percentile	75th Percentile	Skewness	Kurtosis
RPT	0.097	0.010	0.219	0.000	0.083	3.833	19.950
RP complex	0.057	0.000	0.167	0.000	0.013	4.107	21.364
RP simple	0.033	0.003	0.076	0.000	0.029	4.168	24.341
RP loan	0.010	0.000	0.109	0.000	0.008	0.456	20.340
Δ RPT	0.010	0.000	0.109	-0.001	0.008	0.455	20.295
Δ RP complex	0.005	0.000	0.064	0.000	0.000	0.322	26.077
Δ RP simple	0.006	0.000	0.062	-0.0001	0.003	2.416	24.713
Δ RP loan	0.003	0.000	0.038	0.000	0.000	2.789	23.692

Notes: The data is winsorised to the top and the bottom at 1%. The data of RP transactions and its classifications are scaled by the opening total assets. RPT, RP complex, RP simple, and RP loan are referred to as magnitude of the transaction. Δ RP, Δ RP complex, Δ RP simple, and Δ RP loan as a change in magnitude (abnormal) of the transaction. The skewness (kurtosis) for non-winsorised RP transactions is not reported.

Table 6.2 shows the descriptive statistics for the dependent variables and other independent variables. A *DAC* has a mean value of 8 percent and a median of 5 percent with a standard deviation 10.1%, while the *PMDAC* has a mean (median) of 7.4 percent (5.1 percent). The mean value suggests that a discretionary accrual is about 8 percent of the beginning total assets, and the average of discretionary accrual shrinks, to about 7.4 percent after controlling the potential effect of firms' unusual previous performance. These statistics indicate the

discretionary accruals that are managed by the firms over the three-year period are close to 10 percent of the beginning total assets.

Table 6.2
Descriptive statistics of the variables

n=1,195	Mean	Median	Std. Deviation	25th percentile	75th percentile
<i>DAC</i>	0.080	0.050	0.101	0.023	0.102
<i>PMDAC</i>	0.074	0.051	0.077	0.023	0.097
<i>GROWTH</i>	0.732	0.476	0.864	0.271	0.844
<i>FSIZE</i>	12.685	12.752	1.827	11.240	13.818
<i>DEBT</i>	0.148	0.119	0.141	0.027	0.223
<i>BSIZE</i>	9.038	9.000	3.012	7.000	11.000
<i>BDIND</i>	0.429	0.400	0.131	0.333	0.500
<i>ACIND</i>	0.906	1.000	0.148	0.750	1.000
<i>AOPIN</i>	0.959	1.000	0.198	1.000	1.000
<i>AUDFIRM</i>	0.732	1.000	0.443	0.000	1.000
<i>TENURE</i>	5.910	7.000	1.873	5.000	7.000
<i>CSOWN</i>	0.354	0.324	0.182	0.213	0.490
<i>CSTYPE</i>	0.433	0.000	0.496	0.000	1.000
<i>MOWN</i>	0.081	0.003	0.148	0.000	0.080
<i>RISK</i>	9.320	9.206	1.762	8.027	10.442

where: *DAC*= an absolute discretionary accruals based on Modified Jones Model (1995); *PMDAC*= an absolute performance matched discretionary accruals based on Kothari Model (2005); *GROWTH* = the market value of the firm at the end of year *t* divided by book value of the total assets; *FSIZE* = natural logarithm of total assets; *DEBT* = a ratio of total debt to total assets; *BSIZE* = a board size based on actual members of the board of directors; *BDIND* = a proportion of independent non-executive directors to total board members; *ACIND* = a proportion of independent non-executive members to total members of the audit committee; *AOPIN* = an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* = an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* = an actual tenure of auditor and client engagement; *CSOWN* = a percentage of ownership belongs to the controlling shareholder; *CSTYPE* = an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* = a percentage of managerial ownership; *RISK* = an operating risk measured based on three years earnings standard deviation. All variables are winsorised at the top and the bottom at 1%.

I include three groups of control variables that represent a business's characteristics (*GROWTH*, *FSIZE*, *DEBT*, and *RISK*), corporate governance (*BSIZE*, *BDIND*, *ACIND*, *CSOWN*, *CSTYPE*, and *MOWN*), and audit quality (*AOPIN*, *AFIRM*, and *TENURE*). The descriptive statistics in Table 6.2 show the mean (median) of the firm's growth (*GROWTH*) is 0.732 (0.476), firm's size (*FSIZE*) is 12.685 (12.752), firm's leverage (*DEBT*) is 0.148 (0.119), and firm's operating risk is 9.320 (9.206). The standard deviations of these variables are within the range 0.141-1.827, which suggests the variables are not widely

dispersed around the mean. Table 6.2 also shows that the corporate governance variable, *BSIZE*, has an average of nine members and a median of nine members. The mean (median) of *BDIND* is 0.429 (0.400), and the mean (median) of *ACIND* is 0.906 (1.000). The statistics suggest that on average, listed firms in our sample have 42.9 percent (40 percent) of independent non-executive directors, and 90.6% (100 percent) as members of the audit committee.

A mean (median) of the *AOPIN* is 0.959 (1.000), the *AUDFIRM* is 0.732 (1.000), and the *TENURE* is 5.91 (7.000). On average, the listed firms in our sample received unqualified opinion, of which 73.2 percent are audited by a Big 4 audit firm. The *TENURE* suggests that the listed firms have retained the same auditor for six years. On average, controlling shareholders (*CSOWN*) held about 35.4 percent of the equity ownership with the median being 32.4 percent, where on average, 43.3 percent of them are individuals or a family group. At this level of ownership, the controlling shareholders are predicted to entrench minority shareholders' interests. The statistic also shows that managerial ownership is low with the mean (median) being 8.1 percent (0.3 percent) of the equity ownership of these firms.

6.2.1 Correlation and Multicollinearity

In the presence of multicollinearity, the OLS estimator is still *BLUE* as the best linear unbiased estimator (Kennedy, 1998). Farrar and Glauber (1967) suggest that a harmful level of multicollinearity is not present until the correlation coefficient reaches 0.8. Table 6.3 presents a Pearson's correlation matrix for *DAC* and *PMDAC* models. The Pearson's

correlation matrix indicates that there is no unreasonably high correlation present among the independent variables. The highest correlation is *BDSIZE* and *SIZE* (the coefficient is 0.47), and the second highest is *BDIND* and *BSIZE* with the coefficient is -0.40). The third highest correlation is between *AFIRM* and *FSIZE* with the coefficient being 0.34, where a high correlation is expected for both variables. The correlations with other variables are below 0.50. Consistent with Farrar and Glauber (1967), this can be interpreted as not indicating an unacceptable level of multicollinearity being present between independent variables in these *DAC* and *PMDAC* models. Additionally, a robustness check has been carried out for the correlation analysis using non-parametric Spearman's correlation matrix (unreported), and the results are consistent. Significant levels shown in the non-parametric measure appear to coincide with the parametric measure. The correlations confirm there is no multicollinearity problem that is consistent with Farrar and Glauber (1967). Nevertheless, the correlation of *BDSIZE* and *SIZE*, and the correlation of *BDIND* and *BSIZE* are considered high. This issue will be reviewed again using Variance Inflation Factor (VIF) analysis.

Table 6.3 also shows that RP transactions, RP complex, RP simple, RP loan, Δ RP transactions, Δ RP complex, Δ RP simple, and Δ RP loan do correlate with each other. However, it should be emphasized that all these testing variables are examined separately. The analysis confirms that the RP transactions are positively correlated with *GROWTH* (0.07), *BSIZE* (0.23) and *ACIND* (0.12), and negatively associated *BDIND* (-0.16) and *CSTYPE* (-0.10). The RP complex is correlated with *BDSIZE* (0.19), and *ACIND* (0.10), but the correlation is negative with *BDIND* (-0.16) and *CSTYPE* (0.10). The RP simple has a positively correlation with *GROWTH* (0.12), *DEBT* (0.07), *BSIZE* (0.15), and *ACIND* (0.10), in contrast, has a negative correlation with *BDIND* (-0.09). The univariate test results in

Table 6.3 also show that ΔRP , ΔRP complex, and ΔRP simple are not correlated with any control variables at a significant level $p < 0.01$.

6.2.2 Heteroskedasticity

The effect of heteroskedasticity is assessed using White's (1980) procedure. The test is based on auxiliary regression of the squared residuals on all possible cross-products of the regressors. An $Obs \cdot R^2$ is the White's test statistic asymptotically distributed as a Chi-square with degrees of freedom equal to the number of slope coefficients in the regression. This test is also a general test for misspecification if the residuals violate homoscedasticity and independence of the regressor's assumptions. In the presence of heteroskedasticity, the *OLS* estimates are consistent but standard errors are not valid. All multivariate regressions for both *DAC* and *PMDAC* models have significant heteroskedasticity problems as indicated by $Obs \cdot R^2$ (the value is enclosed in the multivariate tables). All multivariate regressions are repeated to adjust the t-statistics based on White's heteroskedasticity-consistent standard errors and covariance. The results for *DAC* models are presented in Table 6.4A and Table 6.4B, while the results for *PMDAC* models are presented in Table 6.5A and Table 6.5B.

6.3 Multivariate Analysis for *DAC*

I adopted pooled regression to create a larger number of data points, thereby increasing the degrees of freedom and reducing estimation problems with collinearity among explanatory variables. It also helps provide more efficient estimates and inferences (Gujarati, 2003). To examine the effect of RP transaction and its classification types on earnings quality, this study uses prediction errors (*DAC*) as a dependent variable in representing earnings quality.

Table 6.3: Pearson's Correlation Matrix

	RP	RP complex	RP simple	ΔRP	ΔRP complex	ΔRP simple	GROWTH	SIZE	DEBT	AOPIN	AUDFIRM	TENURE	BSIZE	BDIND	ACIND	CSOWN	CSTYPE	MOWN
RP complex	0.90*																	
RP simple	0.50*	0.13*																
ΔRP	0.40*	0.29*	0.35*															
ΔRP complex	0.08*	0.10*	-0.04	0.55*														
ΔRP simple	0.29*	0.04	0.64*	0.62*	-0.02													
GROWTH	0.07*	0.04	0.12*	0.04	0.01	0.06												
SIZE	0.00	-0.03	0.00	0.01	-0.01	0.02	0.02											
DEBT	-0.01	-0.04	0.07*	0.02	-0.01	0.03	-0.06	0.34*										
AOPIN	0.03	0.01	0.05	0.02	0.00	0.02	0.06	0.06	-0.01									
AUDFIRM	0.03	0.02	0.06	-0.03	-0.03	0.01	0.04	0.34*	0.10*	0.06								
TENURE	-0.03	-0.01	-0.02	0.02	0.02	-0.01	0.02	0.18*	0.03	0.06	0.33*							
BSIZE	0.23*	0.19*	0.15*	0.04	0.01	0.06	0.08*	0.47*	0.16*	0.07*	0.18*	0.08*						
BDIND	-0.16*	-0.16*	-0.09*	-0.03	0.00	-0.05	0.01	-0.01	-0.01	-0.02	-0.05	-0.04	-0.40*					
ACIND	0.12*	0.10*	0.10*	0.03	0.00	0.04	0.04	0.12*	0.12*	0.05	0.05	-0.05	0.18*	0.26*				
CSOWN	0.02	0.05	-0.05	0.02	0.01	-0.02	0.09*	0.19*	-0.01	0.10*	0.14*	0.02	0.06	-0.05	-0.03			
CSTYPE	-0.10*	-0.10*	-0.03	-0.02	0.00	0.01	-0.11*	-0.23*	-0.03	-0.05	-0.14*	-0.04	-0.23*	0.07	0.02	-0.11*		
MOWN	-0.03	-0.02	-0.01	0.00	0.01	0.00	-0.06	-0.12*	0.00	0.04	-0.12*	-0.04	-0.04	-0.04	0.08*	-0.11*	0.33*	0.32*
RISK	-0.01	-0.01	0.01	0.01	0.00	0.04	-0.08*	-0.12*	-0.06	-0.07	-0.03	-0.03	-0.06	0.01	-0.03	-0.04	0.08*	0.04

where: *DAC* = an absolute discretionary accruals based on Modified Jones Model (1995); *PMDAC* = an absolute performance matched discretionary accruals based on Kothari Model (2005); *GROWTH* = the market value of the firm at the end of year *t* divided by book value of the total assets; *FSIZE* = natural logarithm of total assets; *DEBT* = a ratio of total debt to total assets; *BSIZE* = a board size based on actual members of the board of directors; *BDIND* = a proportion of independent non-executive directors to total board members; *ACIND* = a proportion of independent non-executive members to total members of the audit committee; *AOPIN* = an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* = an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* = an actual tenure of auditor and client engagement; *CSOWN* = a percentage of ownership belongs to the controlling shareholder; *CSTYPE* = an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* = a percentage of managerial ownership; *RISK* = an operating risk measured based on three years earnings standard deviation. All variables are winsorised at the top and the bottom at 1%. *Year*, *Industry*, and *Country* variables are not reported for succinctness, but there is no multicollinearity issue within these variables.

* denote significant at the 0.01 level (two-tailed)

Multivariate regressions are carried out to investigate the association between RP transaction and its classifications and *DAC*. The Eq. 5.6 includes control variables that represent firm characteristics, these being size, leverage, growth, performance and risk (Young, 1998). The governance characteristics comprise audit quality, board and audit committee characteristics.

$$\begin{aligned}
 DAC_{i,t} = & \beta_0 + \Sigma(\beta_{1h}RPTYPE_{i,t}) + \beta_2GROWTH_{i,t} + \beta_3FSIZE_{i,t} + \beta_4DEBT_{i,t} + \beta_5AOPIN_{i,t} \\
 & + \beta_6AUDFIRM_{i,t} + \beta_7TENURE_{i,t} + \beta_8BDSIZE_{i,t} + \beta_9BDIND_{i,t} + \beta_{10}ACIND_{i,t} \\
 & + \beta_{11}CSOWN_{i,t} + \beta_{12}CSTYPE_{i,t} + \beta_{13}MOWN_{i,t} + \beta_{14}RISK_{i,t} + \beta_{15}\Sigma_{ij}^3 Year_{i,t} \\
 & + \beta_{16}\Sigma_{ij}^4 Industry_{i,t} + \beta_{17}\Sigma_{ij}^4 Country_{i,t} + \varepsilon_{i,t}
 \end{aligned}
 \tag{Eq.5. 6}$$

RP transactions are measured using magnitude and abnormal (magnitude change) RP transactions that are scaled to the opening total assets. I analyze the effect of RP transactions in two stages. It begins with considering RP transactions representing a total of the transaction as a base model. I alternate the testing variable (RP transactions) with RP complex, RP simple, or RP loan in separate regressions to distinguish the effect of each type of RP transaction classification.

6.3.1 Magnitude RP Transactions

I examine the effect of magnitude RP transactions and each transaction type on earnings quality (*DAC*) using 420 firms that include 1,231 observations. Results of the regression are presented in Table 6.4A. R^2 of the Model 1 is 8.6% while an adjusted R^2 is 7.0%. An outcome of the correlation analysis employing Variance Inflation Factor (VIF) shows that the VIF value of each variable is less than 5 (see Appendix V) which confirms there is no multicollinearity problem. Model 1 in Table 6.4A shows that the coefficient of magnitude RP transactions is positive, 0.027 and statistically significant at level $p < 0.01$, associated with *DAC*, the discretionary accruals. Therefore, hypothesis H1 does suggest RP transactions are

positively associated with discretionary accruals. The outcome of the multivariate analysis supports the argument that RP transactions confirm this risk. The use of RP transactions increases discretionary accruals that may lead to reduced earnings quality. This conclusion indicates that RP transactions reduce earnings quality, whereby an increase in magnitude of RP transactions raises the likelihood of earnings manipulation.

Table 6.4A
Effects of RP transactions on Discretionary Accrual, modified Jones model
(Magnitude RP Transactions)

n=1,231	Model 1: RP		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
Variable	coefficient	t-stat	Coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constants	0.210***	32.37	0.210***	32.12	0.211***	28.63	0.209***	39.83
RP	0.027***	3.25						
RP complex			0.020	1.52				
RP simple					0.076***	5.62		
RP loan							-0.026	-0.63
GROWTH	0.009***	5.48	0.010***	5.30	0.009***	4.58	0.010***	5.54
FSIZE	-0.010***	-5.15	-0.010***	-4.97	-0.010***	-5.16	-0.010***	-5.12
DEBT	0.085**	2.36	0.091***	2.58	0.081**	2.23	0.090**	2.48
AOPIN	-0.008**	-2.33	-0.007**	-2.25	-0.009***	-3.08	-0.007**	-2.14
AUDFIRM	0.004	0.94	0.004	1.00	0.003	0.73	0.004	0.99
TENURE	-0.002**	-2.19	-0.002**	-2.09	-0.002**	-2.09	-0.002*	-1.93
BSIZE	-0.002*	-1.71	-0.002*	-1.67	-0.002*	-1.68	-0.002*	-1.67
BDIND	-0.017	-0.43	-0.018	-0.46	-0.020	-0.47	-0.021	-0.51
ACIND	0.004	0.76	0.004	0.72	-0.007	0.91	-0.006	-0.89
CSOWN	0.028**	2.01	0.028*	1.92	0.031**	2.19	0.028**	2.12
CSTYPE	0.016*	1.94	0.016*	1.92	0.015*	1.86	0.015*	1.81
MOWN	-0.056***	-3.61	-0.056**	-3.61	-0.055***	-3.71	-0.056***	-3.65
RISK	0.003***	5.50	0.003***	5.39	0.003***	5.46	0.003***	5.38
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	7.00%		7.00%		6.90%		6.90%	
Obs* R ²								
(White, 1980)	421.08***		420.40***		438.97***		416.56***	

where: *DAC* = absolute discretionary accrual based on Modified Jones Model (1995) and calculated as Eq. 5.5; *RPTYPE* = represents one of the following vectors describing a magnitude or abnormal accrual of total RP transactions, RP complex, Simple, Loan, Δ RPT, Δ Complex, Δ Simple, and Δ Loan; *GROWTH* = the market value of the firm at the end of a year *t* divided by book value of the total assets; *FSIZE* = a natural logarithm of total assets; *DEBT* = a ratio of total debt over total

assets; *BSIZE* = a board size based on actual members of the board of directors; *BDIND* = a proportion of independent non-executive directors to total board members; *ACIND* = a proportion of independent non-executive members to total members of the audit committee; *AOPIN* = an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* = an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* = an actual tenure of auditor and client engagement; *CSOWN* is a percentage of ownership belongs to the controlling shareholder; *CSTYPE* = an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* = a percentage of managerial ownership; *RISK* = an operating risk measured based on three-year earnings standard deviation; *Year* = a vector of year indicator variables 2008, 2009, and 2010; *Industry* = a vector of industry indicator variables based on the GICS industry classification; *Country* = a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. Year, industry, and country variables are not reported for brevity.

Table 6.4A also shows that control variables, *GROWTH* (0.009), *DEBT* (0.085), *CSOWN* (0.028), *CSTYPE* (0.016), and *RISK* (0.003) have a positive and significant association with *DAC*, in contrast to *FSIZE* (-0.010), *AOPIN* (-0.008), *TENURE* (-0.002), *BSIZE* (-0.002), and *MOWN* (-0.056) which are negatively related to *DAC*. The variables *GROWTH*, *FSIZE*, *MOWN*, and *RISK* are significant at level $p < 0.01$, while *DEBT*, *AOPIN*, *TENURE*, and *CSOWN* are significant at level $p < 0.05$. These associations are consistent with the prediction that a firm's growth, leverage, and risk increase the potential for accrual management. Consistent with this prediction, the existence of controlling shareholder (*CSOWN*) and individual or family controlling shareholders (*CSTYPE*) also increase the odds of earnings manipulation. Good corporate governance such as board size (*BSIZE*), clean audit reports (*AOPIN*), audit quality (*TENURE*), and managerial ownership (*MOWN*) could prevent opportunistic managers or controlling shareholders from managing accruals deceptively.

Additionally, the differentiation impacts of each type of RP transaction on earnings quality are tested. The segregation of RP transactions into several groups is expected to reduce the models' explaining power. However, Table 6.4A shows that the adjusted R^2 of Model 2, Model 3 and Model 4 are constant at 7.0%, 6.9%, and 6.9%, respectively. Model 2 in Table

6.4A shows that magnitude RP complex has a positive coefficient (0.020), but is insignificantly related to *DAC*. The association indicates that RP complex is not associated with accrual management activity, which suggests accepting the null hypothesis, *H1a*. Table 6.4A, Model 3 shows the results for the effect of magnitude RP simple on *DAC*. The coefficient of magnitude RP simple is 0.076, positive and significant at level $p < 0.01$, showing a strong association with *DAC*. This finding suggests that magnitude RP simple is utilized opportunistically by managers or controlling shareholders to manipulate earnings in their favor. I therefore accept the hypothesis, *H1b*.

A separation of magnitude RP loan from RP simple has a negative coefficient but an insignificant relationship to *DAC* (-0.026). It suggests rejecting the hypothesis *H1c*. Model 2, Model 3, and Model 4 in Table 6.4A also document the results of control variables are consistent with the base Model 1. Variables, *GROWTH*, *DEBT*, *CSOWN*, *CSTYPE*, and *RISK* have positive and significant coefficients, related to *DAC*. The coefficients of *FSIZE*, *AOPIN*, *TENURE*, *BSIZE*, and *MOWN* are negatively associated with *DAC*.

6.3.2 Abnormal RP Transactions

I repeat all the regression using an alternative measure, i.e. abnormal RP transactions. The regression uses a sample consisting of 419 firms and total number of observations being 1,231. The results are presented in Table 6.4B. The adjusted R^2 of Model 1 is 5.6% in explaining the association between RP transactions and *DAC*. Results of VIF (see Appendix II) also confirm that the model is free from multicollinearity. The model shows that only *DEBT* (0.048; $p < 0.05$), *CSTYPE* (0.011; $p < 0.10$) and *RISK* (0.02; $p < 0.01$) have a positive

and significant association with *DAC*. The coefficients of *FSIZE* (-0.007), *AOPIN* (-0.009), *TENURE* (-0.002) and *MOWN* (-0.047) are negatively associated with *DAC*, which is significant at level $p < 0.01$, but *BSIZE* is only significant at level $p < 0.10$. These associations support the results of magnitude RP transactions that showing firm's leverage (*DEBT*), risk (*RISK*), and the presence of individual or family controlling shareholders (*CSTYPE*) increase discretionary accruals. However, a firm's growth (*GROWTH*) and controlling shareholder (*CSOWN*) are insignificant.

Good corporate governance practices such as board size (*BSIZE*), clean audit reports (*AOPIN*), audit quality (*TENURE*), and managerial ownership (*MOWN*) potentially prevent opportunistic accrual manipulation. Model 1 in Table 6.4B shows that the coefficient of the abnormal RP transactions is 0.039 ($t\text{-value} = 2.32$) and significant at level $p < 0.05$, indicating a positive association with *DAC*. This outcome suggests that an increase in a firm's use of RP transactions increases the likelihood of the transaction being used for accruals management. This finding is consistent with magnitude RP transactions and leads to rejecting the null hypothesis, H1.

I then investigate the association between types of RP transaction and *DAC* using the same sample. Model 2, Model 3 and Model 4 in Table 6.4B present results of three separate multivariate regressions - RP complex, RP simple, and RP loan transactions. The adjusted R^2 of Model 2, Model 3, and Model 4 are 5.6%, 6.3%, and 5.4%, respectively. Model 2 in Table 6.4B shows the coefficient of RP complex transactions is 0.005. The result is positive but is not significant that indicates RP complex is not related to *DAC*. Based on this result,

this study accepts null hypothesis H1a. The effect of abnormal RP simple transaction is shown in Model 3 in Table 6.4B. The result shows that the coefficient of abnormal RP simple transaction is 0.109, positive and significant at level $p < 0.01$. Thus, I reject the null hypothesis *H1b* as it predicts that RP simple is not associated with *DAC*. This finding means that RP simple is used opportunistically by managers or controlling shareholders to manipulate accruals.

Table 6.4B
Effects of RP transactions on Discretionary Accrual, modified Jones model
(Abnormal RP Transactions)

n=1,231	Model 1: ΔRP		Model 2: ΔRP complex		Model 3: ΔRP simple		Model 4: ΔRP loan	
Variable	coefficient	t-stat	Coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constants	0.192***	111.93	0.186***	66.58	0.187***	61.74	0.192***	43.6
ΔRP	0.039**	2.32						
ΔRP complex			0.005	0.61				
ΔRP simple					0.109***	3.20		
ΔRP loan							0.053*	1.87
GROWTH	0.000	1.32	0.006***	5.06	0.006***	3.75	0.000	1.04
FSIZE	-0.007***	-6.51	-0.007***	-6.05	-0.007***	-6.20	-0.007***	-6.71
DEBT	0.048**	2.03	0.046*	1.87	0.046*	1.94	0.044*	1.80
AOPIN	-0.009***	-3.05	-0.010***	-3.26	-0.010***	-3.89	-0.009***	-2.91
AUDFIRM	0.002	0.44	0.002	0.30	0.001	0.29	0.002	0.32
TENURE	-0.002***	-4.51	-0.002***	-3.41	-0.002***	-4.71	-0.002***	-3.75
BSIZE	-0.002*	-1.65	-0.002*	-1.90	-0.002*	-1.83	-0.002*	-1.72
BDIND	-0.002	-0.10	-0.004	-0.14	-0.003	-0.10	-0.001	-0.03
ACIND	-0.005	-1.52	-0.004	-1.26	-0.003*	-1.85	-0.004	-1.20
CSOWN	0.020	1.40	0.020	1.36	0.021	1.42	0.022	1.50
CSTYPE	0.011*	1.74	0.012*	1.86	0.011**	2.01	0.011*	1.72
MOWN	-0.047***	-4.55	-0.045***	-4.12	-0.045***	-4.39	-0.047***	-4.89
RISK	0.002***	6.67	0.002***	8.03	0.002***	9.94	0.002***	8.42
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R^2	5.63%		5.60%		6.30%		5.40%	
Obs* R^2	407.36***		394.76***		383.27***		352.90***	

where: *DAC* = absolute discretionary accrual based on Modified Jones Model (1995) and calculated as Eq. 5.5; *RPTYPE* = represents one of the following vectors describing a magnitude or abnormal accrual of total RP transactions, RP complex, Simple, Loan, Δ RPT, Δ Complex, Δ Simple, and Δ Loan; *GROWTH* = the market value of the firm at the end of a year *t*

divided by book value of the total assets; *FSIZE* = a natural logarithm of total assets; *DEBT* = a ratio of total debt over total assets; *BSIZE* = a board size based on actual members of the board of directors; *BDIND* = a proportion of independent non-executive directors to total board members; *ACIND* = a proportion of independent non-executive members to total members of the audit committee; *AOPIN* = an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* = an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* = an actual tenure of auditor and client engagement; *CSOWN* is a percentage of ownership belongs to the controlling shareholder; *CSTYPE* = an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* = a percentage of managerial ownership; *RISK* = an operating risk measured based on three-year earnings standard deviation; *Year* = a vector of year indicator variables 2008, 2009, and 2010; *Industry* = a vector of industry indicator variables based on the GICS industry classification; *Country* = a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. *Year*, *industry*, and *country* variables are not reported for brevity. The coefficient of ΔRP is closely significant at $p=0.0612$; <0.05 .

Model 4 in Table 6.4B shows that RP loan has a positive coefficient, is significant at level $p<0.10$ and is related to *DAC*. The association may become weakened but the separation of RP loan from RP simple shows it may make a potential contribution to accrual management. The results also show the coefficient of abnormal RP simple is 0.109 which is larger than the coefficient for RP loan (0.053). These findings suggest that a combination of RP loan and another component of RP simple are heavily used as tools to manage accruals, which could reduce earnings quality.

6.4 Multivariate Analysis for *PMDAC*

I repeat the multivariate regression using a performance-matched discretionary accruals (*PMDAC*) model developed by Kothari et al. (2005). This model investigates the relationship between RP transactions including their classifications and discretionary accruals in order to avoid past financial experience ending up as misleading results. Thus, the estimation model could ensure the robustness of results. This study uses a prediction error in equation 5.8 to represent *PMDAC*. I also include variables to control cross-sectional differences in firm characteristics (Young, 1998), governance structure and audit quality. The Eq. 5.9 is shown below to describe and measure those variables discussed in Chapter 5.

$$\begin{aligned}
PMDAC_{i,t} = & \beta_0 + \Sigma(\beta_{1h}RPTYPE_{i,t}) + \beta_2GROWTH_{i,t} + \beta_3FSIZE_{i,t} + \beta_4DEBT_{i,t} \\
& + \beta_5AOPIN_{i,t} + \beta_6AUDFIRM_{i,t} + \beta_7TENURE_{i,t} + \beta_8BDSIZE_{i,t} + \beta_9BDIND_{i,t} \\
& + \beta_{10}ACIND_{i,t} + \beta_{11}CSOWN_{i,t} + \beta_{12}CSTYPE_{i,t} + \beta_{13}MOWN_{i,t} + \beta_{14}RISK_{i,t} \\
& + \beta_{15}\Sigma^3_{i,j}Year_{i,t} + \beta_{16}\Sigma^4_{i,j}Industry_{i,t} + \beta_{17}\Sigma^4_{i,j}Country_{i,t} + \varepsilon_{i,t} \quad Eq.5. 9
\end{aligned}$$

Consistent with the *DAC* model, this study also measures RP transactions using magnitude and abnormal RP transactions, which are scaled to the opening total assets. The analysis begins with total RP transactions as a base model. Further, I explore the differential types of RP transaction using separate regressions.

6.4.1 Magnitude RP Transactions

I examine the effect of magnitude RP transactions on *PMDAC* using a sample of 419 firms consisting of 1231 observations. The results are documented in Table 6.5A and it shows the adjusted R^2 of Model 1 is 6.7%. The White's test result shows that the $Obs \cdot R^2$ is 383.31; significant at level $p < 0.01$, and means the model suffered heteroskedasticity problems. Therefore, I present t-statistic results as based on White's (1980) consistent estimator in the presence of heteroskedasticity. This study also finds results for the variance test (VIF) do confirm that these models are free of the multicollinearity issue. The results show that VIF value of each variable is less than 5 (see Appendix V).

Firstly, I find that control variables of *GROWTH* (0.019) and *RISK* (0.001) have a positive association with *PMDAC* and is statistically significant at level $p < 0.01$, and *CSOWN* (0.024) is significant at level $p < 0.10$. These associations are consistent with the prediction

that a firm's growth and risks are associated with discretionary accruals. These linkages are also consistent with the modified Jones model. However, the firm's leverage (*DEBT*) is insignificant and firm size is negatively associated with *PMDAC*. This model also shows that good corporate governance practices reduce discretionary accruals. I also find that clean audit opinion (*AOPIN*), board size (*BSIZE*), an independent audit committee (*ACIND*) and managerial ownership (*MOWN*) reduce *PMDAC*. These relationships are statistically significant at level $p < 0.01$ and $p < 0.05$. Nevertheless, audit quality attributes (*AFIRM* and *TENURE*) are insignificant. Then, the coefficient of magnitude RP transaction is 0.011 as shown in Table 6.5A, is positive and statistically significant at level $p < 0.01$ and associated with *PMDAC*. This outcome indicates that RP transactions are related to discretionary accruals. After controlling the firm's previous financial experience, I find this result is consistent and suggests a firm's use of RP transactions increases the potential of accrual manipulation. Furthermore RP transactions can compromise earnings quality, and the null hypothesis, H1 is rejected; there is no association between RP transactions and discretionary accruals.

Testing the effect of RP complex, RP simple, and RP loan on *PMDAC* uses the sample consisting of 419 firms with 1,231 observations. The results are shown in Model 2, Model 3, and Model 4 in Table 6.5A. The adjusted R^2 of Model 2, Model 3, and Model 4 are 6.7%, 7.8%, and 6.92%, respectively. Model 2 presents the effects of magnitude RP complex on *PMDAC*. I find the coefficient of RP complex is negative but not significant, which suggests a rejection of hypothesis H1a. This finding indicates that there is no evidence RP complex is opportunistically used as a tool in managing accruals.

Table 6.5A
Effect of RP transactions on Performance Matched Discretionary Accruals (PMDAC)
(Magnitude RP Transactions)

n=1,231	Model 1: RP		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
Variable	coefficient	t-stat	coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constants	0.135***	11.28	0.134***	11.84	0.138***	9.32	0.132***	12.25
RP	0.011***	4.60						
RP complex			-0.005	-0.80				
RP simple					0.117 ***	6.78		
RP loan							0.009***	3.03
GROWTH	0.019 ***	13.51	0.019***	13.63	0.018***	14.45	0.019***	13.60
FSIZE	-0.003***	-3.02	-0.003***	-3.01	-0.003***	-3.17	-0.003***	-2.62
DEBT	0.024	1.26	0.023	1.21	0.021	1.09	0.024	1.25
AOPIN	-0.005***	-2.91	-0.004***	-3.34	-0.006***	-2.62	-0.004	-2.88
AUDFIRM	0.001	0.29	0.001	0.27	-0.001	-0.36	0.000	0.25
TENURE	-0.001	-1.59	-0.001	-1.49	-0.001	-1.46	-0.001*	-1.94
BSIZE	-0.002***	-6.27	-0.002***	-6.40	-0.002***	-5.83	-0.002***	-7.08
BDIND	-0.011	-0.49	-0.013	-0.55	-0.012	-0.47	-0.013	-0.55
ACIND	-0.021***	-2.68	-0.020***	-2.66	-0.020**	-2.53	-0.021***	-2.68
CSOWN	0.024*	1.72	0.025*	1.73	0.028**	1.95	0.023	1.53
CSTYPE	0.009	1.60	0.009	1.58	0.009	1.57	0.009	1.59
MOWN	-0.033**	-2.14	-0.033**	-2.15	-0.033**	-2.22	-0.032**	-2.10
RISK	0.001***	3.73	0.001***	3.63	0.001***	3.94	0.001***	3.16
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	6.70%		6.70%		7.80%		6.92%	
Obs*R ²	383.31***		373.52***		386.64***		357.85***	

(White, 1980)

Where: PMDAC is absolute discretionary accrual based on Kothari et al. (2005), calculated by the Eq. 5.8; RPTYPE represents one of the following vectors describing a magnitude or magnitude change of total RP transactions, Complex, Simple, Loan, ΔRP, ΔRP complex, ΔRP simple, and ΔRP loan; GROWTH is the market value of the firm at the end of year t divided by book value of total assets; FSIZE is a natural logarithm of total assets; DEBT is a ratio of total debt over total assets; BSIZE is a board size based on actual members of the board of directors; BDIND is a proportion of independent non-executive directors to total board members; ACIND is a proportion of independent non-executive members to total members on audit committee; AOPIN is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; AUDFIRM is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; TENURE is an actual tenure of auditor and client engagement; CSOWN is a percentage of ownership belongs to the controlling shareholder; CSTYPE is an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; MOWN is a percentage of managerial ownership; RISK is an operating risk measured based on three-year earnings standard deviation; Year is a vector of year indicator variables 2008, 2009 and 2010; Industry is a vector of industry indicator variables based on the GICS industry classification; Country is a vector of country indicator variables, Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) as considering heteroskedasticity. Year, industry, and country variables are not reported for brevity.

I also find that the magnitude RP simple has a positive and significant relationship to *PMDAC*. It is shown in Model 3 where the coefficient is 0.117 and significant at level $p < 0.01$. This further suggests that RP simple is substantially used in managing accruals. Finally, RP loan is positive and significantly associated with *PMDAC* as shown in Model 4. The coefficient of RP loan is 0.009 ($t\text{-value} = 3.03$), indicating that it is significant at $p < 0.01$. These results suggest hypothesis H1b and H1c are true because there is strong association between RP simple, particularly RP loan and discretionary accruals. After controlling the potential effect of the firm's past financial experience, these results validate the modified Jones model.

Further analysis on Model 2, Model 3, and Model 4 find that the control variables are consistent with the base model 1. The control variables *GROWTH*, *CSOWN*, and *RISK* have a positive and significant relationship with *PMDAC*. *DEBT* is insignificant and *FSIZE* is negatively related to *PMDAC*. Similarly, control variables such as *AOPIN*, *BSIZE*, *ACIND*, and *MOWN* have a substantial negative association with *PMDAC*. These associations are consistent with the prediction. However, *DEBT*, *AFIRM*, *TENURE*, *BDIND*, and *CSTYPE* are insignificant. Thus, I conclude that the magnitude RP transactions are likely to be used opportunistically by controlling shareholders to get hold of accruals. RP transactions will impair earnings quality when firms engage in transactions with related parties. The results also indicate that the relationship between RP transactions and discretionary accrual is attributable to RP simple. Consistent with the modified Jones model, these findings propose that managers or controlling shareholders differentiate the usage of each type of RP transactions in manipulating accruals.

6.4.2 Abnormal RP Transactions

The investigation into the effect of abnormal RP transactions on *PMDAC* using 419 firms, consisting of 1,231 observations was repeated. The results are documented in Table 6.5B. The variance inflation factor (VIF) analysis confirms these models are independent of the multicollinearity problems (see Appendix V). However, the White's test results do illustrate some heteroskedasticity. I begin by reviewing control variables in the models and find firms' *GROWTH* and *RISK* have a positive association with *PMDAC*, where the coefficients are 0.017, and 0.001 respectively, and statistically significant at level $p < 0.01$. In contrast, firm size (*FSIZE*) is significantly and negatively associated with *PMDAC*, while a firm's leverage (*DEBT*) is insignificant. The association between these firms' attributes and discretionary accruals is consistent with the prediction, except *DEBT*. I also find that control variables *AOPIN*, *TENURE*, *BSIZE*, *ACIND* and *MOWN* have a negative and significant association with *PMDAC*. These relationships have been predicted to lead to good corporate governance practices, and representing a controlling mechanism that can reduce accrual manipulation. The relationship of these control variables and *PMDAC* is also consistent in Model 2, Model 3, and Model 4.

Model 1 in Table 6.5B shows the adjusted R^2 of Model 1 is 6.9%. The coefficient of abnormal RP transactions is positive (0.038) and statistically significant at level $p < 0.01$, associated with *PMDAC*. This indicates a substantial relationship with discretionary accruals. After matching for the firm's past financial experience, the outcome suggests that increase in abnormality of any contract or arrangement with related parties will increase the risk of managers' or controlling shareholders' accrual management behavior. This means

rejecting the null hypothesis, H1 as predicting no association between RP transactions and *PMDAC*. Table 6.5B also documents the results for the effect of RP transactions on *PMDAC* based on type of transaction, RP complex, RP simple, or RP loan in separate regression. I examine a sample that consists of 419 firms with 1,231 observations. The adjusted R^2 of Model 2, Model 3, and Model 4 are 6.6%, 7.5%, and 3.37%, respectively.

Table 6.5B
Effect of RP transactions on Performance Matched Discretionary Accruals (PMDAC)
(Abnormal RP Transactions)

n=1,231	Model 1: ΔRP		Model 2: ΔRP complex		Model 3: ΔRP simple		Model 4: ΔRP loan	
Variable	coefficient	t-stat	coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constants	0.129***	12.03	0.129***	10.02	0.129***	10.02	0.150***	13.52
ΔRP	0.038***	2.74						
ΔRP complex			-0.021	-0.43				
ΔRP simple					0.121***	4.01		
ΔRP loan							0.023**	2.01
GROWTH	0.017***	13.36	0.018***	14.20	0.017***	15.84	0.003***	7.41
FSIZE	-0.003***	-2.85	-0.003***	-2.71	-0.003***	-2.90	-0.004***	-3.73
DEBT	0.013	0.87	0.013	0.83	0.013	0.92	0.018	0.87
AOPIN	-0.006***	-3.32	-0.005***	-2.90	-0.006***	-2.90	-0.001	-0.55
AUDFIRM	0.001	0.26	0.000	0.13	0.000	0.07	0.001	0.42
TENURE	-0.001**	-2.37	-0.001	-1.54	-0.001**	-2.31	-0.001***	-1.69
BSIZE	-0.002***	-7.91	-0.002***	-8.45	-0.002***	-10.23	-0.002***	-5.48
BDIND	-0.006	-0.33	-0.006	-0.32	-0.005	-0.28	-0.004	-0.15
ACIND	-0.022***	-3.31	-0.023**	-2.93	-0.022***	-3.40	-0.020***	-2.57
CSOWN	0.023*	1.71	0.024*	1.73	0.025*	1.80	0.026*	1.75
CSTYPE	0.007	1.60	0.007	1.58	0.007*	1.68	0.007	1.23
MOWN	-0.029**	-2.09	-0.029**	-2.16	-0.029**	-2.15	-0.038***	-2.66
RISK	0.001***	3.24	0.001***	4.43	0.001***	5.09	0.001***	1.76
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R^2	6.90%		6.60%		7.50%		3.37%	
Obs* R^2 (White, 1980)	396.12***		402.40***		375.61***		393.69***	

where: *PMDAC* is absolute discretionary accrual based on Kothari et al. (2005), calculated by the Eq. 5.8; *RPTYPE* represents one of the following vectors describing a magnitude or magnitude change of total RP transactions, Complex, Simple, Loan, ΔRPT, ΔRP complex, ΔRP simple, and ΔRP loan; *GROWTH* is the market value of the firm at the end of year t divided by book value of total assets; *FSIZE* is a natural logarithm of total assets; *DEBT* is a ratio of total debt over total assets; *BSIZE* is a board size based on actual members of the board of directors; *BDIND* is a proportion of independent

non-executive directors to total board members; *ACIND* is a proportion of independent non-executive members to total members on audit committee; *AOPIN* is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* is an actual tenure of auditor and client engagement; *CSOWN* is a percentage of ownership belongs to the controlling shareholder; *CSTYPE* is an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* is a percentage of managerial ownership; *RISK* is an operating risk measured based on three-year earnings standard deviation; *Year* is a vector of year indicator variables 2008, 2009 and 2010; *Industry* is a vector of industry indicator variables based on the GICS industry classification; *Country* is a vector of country indicator variables, Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. *Year*, *industry*, and *country* variables are not reported for brevity.

Table 6.5B presents the results for Model 2 and shows that the coefficient of RP complex is -0.021, negative but insignificant. Consistent with the modified Jones model, I find no evidence that showing abnormal RP complex is associated with discretionary accruals. This result strengthens a suggestion of rejecting the hypothesis H1a that predicting RP complex is related to discretionary accruals. Contradict with RP complex, Model 3 in Table 6.5B shows that RP simple has a positive relationship to *PMDAC* substantially. The coefficient is 0.121 and statistically significant at level $p < 0.01$. The finding suggests that RP simple a major attribute contributing to the positive relationship between RP transactions and discretionary accruals. This result suggests rejecting null hypothesis H1b that predicting no association. Finally, the result of RP loan is presented in Model 4 of Table 6.5B, which showing a positive relationship between RP loan and *PMDAC*. The coefficient is 0.023 and substantially significant at level $p < 0.05$. This relationship indicates that RP loan is used by opportunistic business people concerning accruals. Consistent with the modified Jones model, this finding suggests rejecting the null hypothesis that predicted no association.

6.5 Discussion of Results

There is empirical evidence for a relationship between RP transactions and certain types of classifications in a firm's accrual management behavior. The investigation utilizes two

different accrual models, these being the modified Jones model (Dechow et al., 1995) and performance-matched discretionary accruals (Kothari et al., 2005). I also use two measures of RP transactions to ensure the results are robust, magnitude and abnormal RP transactions. Based on the modified Jones model, I find both measures produce a consistent relationship between RP transactions and *DAC*. It is evident that RP transactions have a substantial relationship with discretionary accruals that reduce earnings quality. These results suppose that magnitude and abnormal RP simple transaction is a major part of that relationship. The results also prove that abnormal RP loan is associated with *DAC*, which contradicts the magnitude RP loan. Furthermore the results indicate that the magnitude and abnormal RP complex is insignificant.

In the *PMDAC* model, the estimation of *DAC* is controlled by a spurious indication caused by firms having performed unusually in the past. The model finds both magnitude and abnormal RP transactions fabricate a consistent relationship with *DAC*. This means magnitude and abnormal RP transactions have a substantial association with discretionary accruals. The associations are expected to lead to poor earnings quality. The result of the abnormal strengthens the magnitude RP simple as the most important attribute of the relationship. Both measurements show empirically that RP complex is insignificant as much as the magnitude RP loan, but the abnormal RP loan is slightly associated with *DAC*. The findings support the relationship between RP transactions and the differentiation of each type of RP transaction and the managers or controlling shareholders' accrual management behavior. The presence of RP transactions increases the likelihood of earnings manipulation through the deceptive management of accruals. Extending the modified Jones model by

including return on assets (*ROA*) as a control for the firm's past financial performance on the estimated discretionary accruals ensures the results are robust.

These findings imply that RP transactions are used opportunistically by managers or controlling shareholders to manage accruals. The findings also other analyses, namely Gordon et al. (2004), Munir and Mohd-Saleh (2009) and Sumiyana and Rahmat (2012), linking RP transactions to greater likelihood of earnings manipulation through discretionary accruals. Evidence from both models can be interpreted that the manager or controlling shareholders behave differently in treating each type of RP transaction. These people are more likely to manage accrual through RP simple, particularly RP loan. There is no evidence that RP complex is used to manage earnings through accruals. Consequently, these results are considered robust and strengthen the argument that managers or controlling shareholders distinguish between RP transaction types when managing accruals. Their ability to do so depends on the nature and complexity of the transaction.

I conclude that magnitude and abnormal RP transactions reduce earnings quality, where the impact is attributable to RP simple, specifically RP loan. The impact of RP simple is more severe than RP complex transactions. Considering the nature of RP complex, I believe that it is difficult for managers or controlling shareholders to manage accruals through RP complex. The RP complex often includes contracts with a company's subsidiaries, partnerships, or the joint-ventures that usually involve stock and inventory transactions. This kind of internal contract is needed to ensure efficient daily business operations (Gordon et al., 2004; Kohlbeck & Mayhew, 2010). Some RP complex may comprise recurring

contract in order to obtain approval from the board of directors and shareholders. As a result, RP complex should be more transparent than RP simple or any other straight-forward transactions with directors. Therefore, government regulators and policy-makers have to pay more attention to RP simple, particularly the RP loan.

I find that the empirical evidence is consistent with the earnings-discretionary accrual literature. Earnings can be managed using asset sales and/or accelerating or deferring of revenue and expenses using accounting methods and estimates (Peasnell et al., 2000). The incentives for managers or controlling shareholders to manage accruals through manipulating variously classified RP transactions are there for them to maximize any personal gains. These results may be supported by the link between *CSOWN* and *DAC*, and *PMDAC*, which are positive and significant. In addition, *CSOWN* has a mean value of 35% of equity ownership, whereby the ownership range is largely associated with the entrenchment effect (Morck et al., 1988).

An RP loan outcome may be influenced by the small number of firms disclosing RP transactions and their classifications in the sample. No Malaysian listed firms disclosed RP loan over the three-year period after the Malaysian Companies Act 1965 was amended in 2007 and banned such transactions. However, the trend among Malaysian listed firms that they disclosed ‘advances payment’ to or from related parties. Thus, I include these advances payment to or from related parties as RP loan. Most RP loans occurred in Thailand, Hong Kong, and Singapore listed firms.

The potential of a reversal effect of discretionary accrual is also important. The reversal effect could hide the existence of incentives of managers or controlling shareholders in managing accruals. Dechow, Hutton, Kim, and Sloan (2012) emphasize that discretionary accruals are made to deliberately shift earnings between reporting periods. The accrual accounting process requires misstatements in one period to reverse in another period. If a firm understates its payables or receivables in one period, the understatement must be reversed in the subsequent period, but the associated cash flows will not be paid or received. McCulloch (1997) notes the discretionary accruals reverse over the lifetime of the business as part of an ongoing earnings management strategy, thus the accruals would be expected to reverse out over a finite horizon.

Table 6.6
Discretionary Accrual Mean Analysis

Year	Absolute DAC		DAC	
	Mean	Median	Mean	Median
2006	0.098	0.062	-0.022	-0.027
2007	0.101	0.060	0.008	0.000
2008	0.086	0.055	0.008	-0.002
2009	0.067	0.044	-0.004	-0.008
2010	0.088	0.059	0.014	0.001
2011	0.069	0.041	0.009	-0.000

Therefore, I analyze further mean value of the *DAC* by including the pre- and post-investigation periods to confirm that no substantial reversal effect occurred. The results show that the mean values of *DAC* are -0.022 (2006), 0.008 (2007), 0.008 (2008), -0.004 (2009), 0.014 (2010), and 0.009 (2010). Based on this result, there is no substantial reversal effect in discretionary accrual every year. Thus, estimated *DAC* can be associated with incentives to manage accruals. Future research should estimate the discretionary accruals and test the reversal of those accruals in an adjacent period (Dechow et al., 2012).

6.6 Sensitivity Analysis

6.6.1 RP Transactions Firms

A sensitivity analysis is executed for RP transactions' effect on the discretionary accrual by excluding firms without RP transactions. The number of firms engaged in and disclosing RP transactions is 289 for a total of 783 observations. While based on the abnormal RP transactions, I find 293 firms with a total of 813 observations. This shows that the magnitude RP transactions have a positive relationship to *DAC*, in which the coefficient is 0.022 and significant at level $p < 0.01$. This positive association is attributable to RP simple (0.102; $p < 0.01$). However, RP complex and RP loan also have positive coefficients; 0.009 and 0.017, respectively and they are insignificant. The results are consistent with the main findings (see section 6.4). The results for the abnormal measures are also consistent with the main findings. The coefficient of RP transaction is 0.037, significantly associated with *DAC*. The abnormal RP simple (the coefficient, 0.116; $p < 0.01$) and RP loan (the coefficient, 0.065; $p < 0.01$) contribute to the association with the main findings. Otherwise, the abnormal RP loan is insignificant.

This analysis is repeated using the *PMDAC* model. The results show that the coefficient of magnitude RP transactions are positive, 0.011, and significant at level $p < 0.01$. Consistent with the main findings, the coefficients of the magnitude RP complex is insignificant. The evidence also shows clearly that the association between RP transactions and *PMDAC* is attributable to RP simple (0.136), positive and substantially significant at level $p < 0.01$. The result also shows that the magnitude RP loan has a positive coefficient, 0.013; $p < 0.01$, associated with *PMDAC*.

Table 6.7

Partial Results for The Effect of RP Transactions on Earnings Quality (Related Party Firms only)

Panel A: Magnitude RP Transactions

Variable	DAC								PMDAC								
	Model 1:		Model 2:		Model 3:		Model 4:		Model 1:		Model 2:		Model 3:		Model 4:		
	RP		RP complex		RP simple		RP loan		RP		RP complex		RP simple		RP loan		
	β	t	β	t	β	t	β	t		β	t	β	t	β	t	β	t
RP	0.022***	3.26								0.011***	18.96						
RP complex			0.009	0.68								-0.006	-1.25				
RP simple					0.102***	5.32								0.136***	11.71		
RP loan							0.017	0.51								0.013***	3.59
Adjusted R ²	4.38%		3.96%		5.19%		3.92%			7.89%		7.77%		10.53%		8.87%	

Panel B: Abnormal RP Transactions

Variable	DAC								PMDAC								
	Model 1:		Model 2:		Model 3:		Model 4:		Model 1:		Model 2:		Model 3:		Model 4:		
	Δ RP		Δ RP complex		Δ RP simple		Δ RP loan		Δ RP		Δ RP complex		Δ RP simple		Δ RP loan		
	β	t	β	t	β	t	β	t		β	t	β	t	β	t	β	t
Δ RP	0.037*	1.87								0.044***	3.48						
Δ RP complex			0.009	1.35								-0.014	-0.33				
Δ RP simple					0.116***	3.52								0.127***	4.72		
Δ RP loan							0.065***	3.05								0.118**	2.46
Adjusted R ²	4.19%		3.95%		5.33%		4.05%			7.41%		6.81%		8.44%		3.07%	

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

Again, the tests are repeated using the abnormal measures, resulting in RP transactions having a consistent and positive association with *PMDAC*. The coefficient is 0.044, statistically significant at level $p < 0.01$. Thus, the results of the effect for abnormal each type of RP transactions are also consistent with the main findings. The results show that RP simple (the coefficient, 0.127; $p < 0.01$) and RP loan (the coefficient, 0.118; $p < 0.05$) have a positive and significant relationship to *PMDAC*, while RP complex is insignificant. These results emphasize the fact that RP transactions can be used opportunistically by firms' executives to manipulate earnings, specifically via RP simple and RP loan. As result, businesses' earnings quality involves RP transactions impaired (lower) that consistently support the conflict of interest view.

6.6.2 Alternative Measure Abnormal RP Transactions

I run also sensitivity analyses of abnormal RP transactions by using a different measure. Instead of the magnitude change of RP transactions, I use the median value by controlling year-industry-country to determine the unexpected RP transactions for each firm. The objective is to find evidence of the effect of RP transactions on firm's market valuation by using the alternative measure of abnormal RP transactions. The results of the analyses are shown in Table 6.8, Panel A and Panel B.

Based on DAC model, the result shows unexpected (abnormal) RP transactions have a positive association with DAC; the coefficient is 0.011 ($t=5.56$) and significant at level $p < 0.01$. This finding is consistent with the main findings (discussed in section 6.3B). It suggests that RP transactions are used to manage earnings via accruals. Further analyses on

types of RP transactions find that unexpected RP complex (0.022; t=11.62) and RP simple (0.022; t=2.90) have a positive relationship to DAC, and significant at level $p < 0.01$. This evidence substantially indicates that the managers or controlling shareholder may utilize RP complex and RP simple to manage earnings. The likelihood of firm's wealth expropriation increases when managers or controlling shareholders engage in RP complex and RP simple. Table 6.8, Panel A, however, shows RP loan is insignificant that suggesting no evidence of RP loan is used to manipulate earnings.

Table 6.8
Analyses of Abnormal RP Transactions (Measured Based on Median of RP Transactions)

Panel A: DAC Models (n=1,231)

Model Variables	ΔRPT		ΔRP Complex		ΔRP Simple		ΔRP Loan	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
ΔRPT	0.011	5.56***						
ΔRP Complex			0.022	11.62***				
ΔRP Simple					0.022	2.90***		
ΔRP Loan							-0.082	-1.05
Adjusted R ²	7.4%		7.5%		7.4%		7.4%	

Panel B: PMDAC Models (n=1,231)

Model Variables	ΔRPT		ΔRP Complex		ΔRP Simple		ΔRP Loan	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
ΔRPT	-0.004	-0.85						
ΔRP Complex			-0.004	-2.10**				
ΔRP Simple					0.054	15.61***		
ΔRP Loan							0.047	0.90
Adjusted R ²	4.3%		9.1%		6.9%		6.7%	

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests.

All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

I repeat all the regression by using PMDAC model, but I find unexpected RP transactions are insignificant suggesting no association between RP transactions and discretionary

accruals. Further analysis of each type of RP transactions, the results show only RP simple (the coefficient 0.054; $t=15.61$) is positively and significantly associated with discretionary accruals. In contrast, I find the result shows the unexpected RP complex is negatively and significantly associated with discretionary accruals, while RP loan is remained insignificant. These results substantially indicate that the association of unexpected RP transactions and discretionary accruals is mainly attributable to RP simple. It implies that the potential of the wealth expropriation increase when the firms engage in any straight-forward contract with related parties (RP simple) instead of RP complex.

6.6.3 Combined Test of RP Complex and RP Simple

I analyze further by regressing RP complex and RP simple simultaneously in one regression model. The objective of this analysis is to find evidence regarding the effect of RP transactions on earnings quality by considering a potential self-serving behavior may occur through using a combination testing of RP transactions. The results of the analyses are shown in Table 6.9A. Based on magnitude RP transactions, the coefficients of RP simple are 0.108 ($t=5.66$) in DAC model and 0.063 ($t=4.07$) in PMDAC model, significant at level $p<0.01$. These results show that RP simple has a positive association with discretionary accruals, before and after controlling firm's performance. The association of RP complex is also positive and significant (the coefficient is 0.03; $t=7.10$) in PMDAC model but insignificant in DAC model.

I repeat the combining test for alternative measure, abnormal RP transactions and find both RP simple has a positive relationship to DAC (the coefficient 0.138; $t=5.33$) and PMDAC (the coefficient 0.123; $t=3.09$), substantially significant at level $p<0.01$. However, I find that

RP complex is insignificant in both DAC and PMDAC models. The combining test's results show consistently that RP simple is used to manage discretionary accruals, which increase a likelihood of wealth expropriation. While, evidence that suggesting managers or controlling shareholders manage accruals through utilizing RP complex may be not substantial.

Table 6.9A
Combined Test of the Effect of RP Complex & RP Simple on Earnings Quality (Partial Results)

Model Measure Variable	DAC				PMDAC			
	Magnitude		Abnormal		Magnitude		Abnormal	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
RP Complex	-0.003	-0.59			0.030	7.10***		
RP Simple	0.108	5.66***			0.063	4.07***		
Δ RP Complex			-0.025	-0.40			0.002	0.06
Δ RP Simple			0.138	5.33***			0.123	3.09***
Adjusted R ²	8.0%		8.2%		7.3%		7.4%	
Observations	n=1231		n=1231		n=1231		n=1231	

Notes:

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

In the case of RP loan, however, hypothesis H1c could not be tested simultaneously with H1b (RP simple) because a component of RP simple consists of RP loan. It would increase potential of a multicollinearity problem in the regression. Therefore, I do further analyses to run H2a, H2b and H2c simultaneously by excluding RP loan in defining RP simple (H2a). The results are shown in Table 6.9B. Based on magnitude RP transactions, the coefficients of RP simple are 0.138 (t=274) in DAC model and 0.181 (t=4.15) in PMDAC model, significant at level $p < 0.01$. These results show that RP simple (non-RP loan) has a positive association with discretionary accruals, before and after controlling firm's performance. However, I find a contradict result for RP complex, which the association of RP complex is

positive and significant (the coefficient is 0.031; $t=5.78$) in DAC model but insignificant in PMDAC model. Table 6.9B also shows that the results of RP loan are consistent with the main findings (discussed in section 6.3.1 and 6.4.1). The coefficient of RP loan is positive (0.012; $t=2.81$) and significant at $p<0.01$ in PMDAC model but insignificant in DAC model.

Table 6.9B
Combined Test of the Effect of RP Complex, RP Simple without RP Loan (non-RP Loan), and RP Loan on Earnings Quality (Partial Results)

Model Measure Variable	DAC				PMDAC			
	Magnitude		Abnormal		Magnitude		Abnormal	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
RP Complex	0.031	5.78***			-0.005	-0.90		
RP Simple	0.138	2.74***			0.181	4.15***		
RP Loan	-0.014	-0.83			0.012	2.81***		
Δ RP Complex			-0.015	-1.34			-0.022	-0.56
Δ RP Simple			0.085	0.06*			0.086	3.45***
Δ RP Loan			0.005	0.60			0.037	2.08**
Adjusted R ²	8.6%		7.2%		8.2%		4.8%	
Observations	n=1231		n=1231		n=1231		n=1231	

Notes:

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

Table 6.9B also shows that abnormal RP simple (non-RP loan) has a positive relationship to PMDAC (the coefficient 0.037; $t=2.08$), substantially significant at level $p<0.01$. The association between RP simple and discretionary accrual in DAC model is also positive (the coefficient 0.085; $t=0.06$) but only slightly significant at $p<0.10$. I also find that abnormal RP loan is substantially significant at $p<0.05$ (the coefficient is 0.037; $t=2.08$) PMDAC model but the result is insignificant in DAC model. Table 6.9B also shows that RP complex is insignificant in both DAC and PMDAC models. These results consistently indicate that managers or controlling shareholders may utilize RP simple is used to manage discretionary

accruals. The evidence also suggests that managers or controlling shareholders manage accruals through utilizing RP complex and RP loan but maybe not fully substantial.

6.6.4 Economic Significance Test

I run additional analyses to find out the economic significance of the RP transactions to fit the data in the regression models. In average, results of this study suggest that RP transactions have a significance positive association with earnings quality, which indicate that managers or controlling shareholders may utilize RP transactions for opportunistic purposes. Nevertheless, there is no clear indication of the economic significance of RP transactions in the regression model. I re-run the regression by leaving the test variable out each regression and compare the R^2 for basis point declines. The model with more parameters will always be able to fit the data at least as well as the model with fewer parameters. Thus typically model with additional parameter (RP transactions) will give a better (i.e. lower error) fit to the data than the model without such a variable (Markowski & Markowski, 1990). I use F-test to determine the economic significance of RP transactions, whether it inclusion would give a better fit to the data. I illustrate the results of the analyses in Table 6.10.

Based on DAC model, I find that F-value of model with magnitude RP transactions is 3.81, significant at $p < 0.01$. This result shows that RP transactions have an economic significance in the regression model. It implies that the inclusion of the variable gives a better fit to the data. Thus, I can interpret that the negative relationship between RP transactions and firm value substantially caused by the presence of the variable. The result also shows that F-value of the regression model with abnormal RP transactions ($F=2.77$) is significant at

$p < 0.01$. This result supports that the inclusion of abnormal RP transactions has an economic significance in determining its association with earnings quality. However, Table 6.10 show a mix results for each type of RP transactions. I find that F-value of the model with magnitude (F-value = 3.70) and abnormal RP simple (F-value = 8.75) are significant at $p < 0.01$. Table 6.10 also shows that F-value of the model with magnitude RP complex is significant (F-value=1.47; $p < 0.10$) but abnormal RP complex is insignificant. The results also indicate that the inclusion of magnitude and abnormal RP loan do not fit the data that indicating a lack of economic significance.

Table 6.10
Economic Significance Test (F-Test)

	DAC			PMDAC		
	R Square		F-value	R Square		F-value
	Control Model	Testing Model		Control Model	Testing Model	
RPT	0.083003	0.085887	3.81***	0.083158	0.083901	0.98
RP Complex	0.085686	0.086797	1.47*	0.083158	0.083246	0.12
RP Simple	0.083003	0.0858	3.70***	0.083158	0.094601	15.27***
RP Loan	0.085686	0.085813	0.17	0.083158	0.085889	3.61***
Δ RPT	0.07109	0.073217	2.77***	0.082485	0.085289	3.70***
Δ RP Complex	0.073308	0.073321	0.02	0.082485	0.082829	0.45
Δ RP Simple	0.073308	0.079970	8.75***	0.082485	0.091296	11.71***
Δ RP Loan	0.069962	0.070821	1.12	0.049709	0.050943	1.57**
N	1,231			1,231		

Note:

***, **, * Indicator that the variable significant at 1%, 5% and 10% respectively.

Based on the PMDAC model, the results are also mixed. Table 6.10 shows that the F-value of the regression that include abnormal RP transactions are F-value = 3.70, significant at $p < 0.01$. However, the F-value of the regression model to include magnitude RP transactions is insignificant. Further tests on types of RP transactions show that magnitude and abnormal RO complex do not have economic significances in the regression models as the F-values

are insignificant. The F-value of magnitude (15.27) and abnormal RP simple (11.71) are significant at $p < 0.01$ that indicate its inclusion could fit to the data. Contradict with the DAC model, Table 6.10 shows that magnitude RP loan (F-value=3.61, $p < 0.01$) and abnormal RP loan (F-value= 1.57, $p < 0.05$) indicate that RP loan has substantial economic significance to the regression models. In overall, the F-test's results imply that the additional of RP transactions and each type of the transaction could fit to the data in the regression models. Thus, it can be concluded the models are specified in determining the association between RP transactions (including RP complex, RP simple and RP loan) and earnings quality.

6.7 Summary and Conclusion

The effects of RP transactions and each classification on earnings quality were investigated in this chapter. I used the discretionary accrual to represent earnings quality. The findings do postulate managers or controlling shareholders will exploit RP transactions opportunistically for managing accruals in their favor. This chapter employed two accrual-based models, i.e. the modified Jones model (Dechow et al., 1995) and performance-matched discretionary accrual model (Kothari et al., 2005) to obtain the results. These results are robust, showing that the presence of RP transactions increases the likelihood of accrual earnings management by managers or controlling shareholders. The links are strengthened using two different measures, magnitude and abnormal RP transactions. The associations empirically suggest that RP transactions reduce earnings quality and the argument that RP transactions result in conflict of interest rather than an efficient and legal transaction.

The evidence also indicates that managers or controlling shareholders maximize RP simple in managing accruals. This study finds that the results are consistent and robust. The managers or controlling shareholders may fully utilize RP simple which refers to a transaction with directors who are either individuals or part of a family ownership structure. Thus, RP complex is more difficult to be manipulated than RP simple because the transaction usually involves dealings that are required for ensuring continuity of daily business operation. These findings support differences within each type of RP transaction (Kohlbeck & Mayhew, 2010), since not all RP transactions are the same (Ryngaert & Thomas, 2012).

Chapter 7

RP Transactions and Firm Valuation

7.1 Introduction

This chapter discusses the market participants' perceptions of RP transactions and each type of classification. It presents a description of the statistics summarizing the dependent variables (Q , MVE and RET), independent variables (RP transactions and each classification type), and control variables. This study examines the independent variables to assess the impact they have on firm valuation, specifically, market performance, market value of equity and share returns. The cross-country analysis relies on the same dataset as used in Chapter 6, and consistently measures RP transactions and each type of classification by using magnitude and abnormal. Magnitude or abnormal RP transactions may influence any changes in the firm's market value. In order to find this evidence, this study uses three firm valuation models: Tobin's Q , earnings-market valuation (MVE), and earnings informativeness model (return-earnings model).

A restricted capacity to prevent RP transactions leads investors or existing shareholders to utilize the stock market to protect against potentially corrupt RP transactions. It can be expected that the variables are significantly negative in explaining lower returns or market values if investors perceive that RP transactions are being used to expropriate wealth. In contrast, if investors perceive that RP transactions represent efficient and effective contracts that ensure a firm's daily operations, the coefficient of the variables is expected to be

positive and significant. Much research finds investors' discount the value of a related party's firm, and consequently this cross-country study predicts that the related party's firms engaged in RP transactions will have a lower market valuation.

This chapter is organized as follows. Section 7.2 provides a descriptive analysis of the variables, correlation, multicollinearity and heteroskedasticity issues. The research findings in the context of market performance, earnings market valuation, and earnings informativeness are outlined in Sections 7.3, 7.4, and 7.5, respectively. Section 7.6 discusses the research findings while Section 7.7 discusses the sensitivity analyses. The final section summarizes this chapter and its main findings.

7.2 Empirical Results

7.2.1 Descriptive Analysis

Table 7.1 presents descriptive statistics of RP transactions scaled using a beginning book value of equity. The data are also winsorised to the point equivalent to the top and bottom at 1% level of the ranked variables. Table 7.1 shows that the mean (median) value of RP transactions is 0.091 (0.005) with a standard deviation of 0.253. Based on the beginning number of shares, this statistic indicates that RP transactions are about 9.1 percent. From this statistic, RP complex represents 5.1 percent and RP simple is about 2.9 percent of the beginning number of shares. RP loan has a mean (median) value of 0.010(0.000) indicating that the magnitude is about 1.0 percent of the beginning number of shares. Table 7.1 also shows the mean (median) of abnormal RP transactions is positive, i.e. 0.011 (0.000). The mean (median) of abnormal RP complex is 0.005 (0.000) and abnormal RP simple is 0.005

(0.000). The positive mean (median) of abnormal RP transaction and its classification indicates a magnitude of RP transactions increasing at about 1.1 percent of the beginning number of shares. The magnitude of RP complex increased less than 0.5 percent, while RP simple increased at about 0.5 percent.

Table 7.1
Descriptive statistics of RP Transactions

Scaled by the Beginning Number of Shares (n=1,231)							
	Mean	Median	Std. Dev.	25 Percentile	75 percentile	Skewness	Kurtosis
RP	0.091	0.005	0.253	0.000	0.055	4.699	27.929
RP complex	0.051	0.000	0.161	0.000	0.005	4.452	24.311
RP simple	0.029	0.001	0.076	0.000	0.020	4.283	23.072
RP loan	0.010	0.000	0.048	0.000	0.000	6.434	46.640
Δ RP	0.011	0.000	0.091	-0.002	0.004	1.396	13.610
Δ RP complex	0.005	0.000	0.058	0.000	0.000	2.639	22.661
Δ RP simple	0.005	0.000	0.055	-0.000	0.002	1.690	17.900
Δ RP loan	0.004	0.000	0.035	0.000	0.000	4.811	35.985

Notes:

The data is winsorised at the top and the bottom at 1%.

RP, RP complex, RP simple, and RP loan are referred to as a magnitude of the transaction.

Δ RP, Δ RP complex, Δ RP simple, and Δ RP loan refer to as a change in magnitude (abnormal) of the transaction.

Table 7.2 shows descriptive statistics for the three dependent variables and other independent variables. These variables have been winsorised to the point of equivalence to the top and bottom at 1% level. The mean (median) *MVE* is 1.079 (0.337), while *Q* has a mean (median) of 0.872 (0.637). The *RET* has a mean of 2 percent and a median of 9.7 percent. The statistics also show that a mean of Δ *EPS* is less than 1 percent (0.008), and a median is 0.3 percent. A mean for *EPS* is about 9.7 percent, while a median is 3.4 percent of the opening share price. *BVE* has a mean (median) of 84.8 percent (40.8 percent) and *EARN* has a mean (median) value of 9.8 percent (3.4 percent) of the beginning number of shares

outstanding. The mean (median) of the firm's growth (*GROWTH*) is 0.771 (0.499), firm's size (*FSIZE*) is 12.685 (12.752), and firm's leverage (*DEBT*) is 0.148 (0.111).

Table 7.2
Descriptive statistics of the variables

n=1,231	Mean	Median	Standard Deviation	25 percentile	75 percentile
MVE	1.079	0.337	2.087	0.131	1.003
RET	0.020	0.097	0.634	-0.390	0.423
Q	0.872	0.637	0.847	0.430	0.980
ΔEPS	0.008	0.003	0.143	-0.017	0.024
EPS	0.097	0.034	0.197	0.005	0.099
BVE	0.848	0.408	1.365	0.165	0.873
EARN	0.098	0.034	0.194	0.005	0.101
GROWTH	0.771	0.499	0.951	0.280	0.861
FSIZE	12.685	12.752	1.827	11.240	13.818
DEBT	0.148	0.119	0.141	0.027	0.223
BSIZE	9.038	9.000	3.012	7.000	11.000
BDIND	0.429	0.400	0.131	0.333	0.500
ACIND	0.906	1.000	0.148	0.750	1.000
AOPIN	0.959	1.000	0.198	1.000	1.000
AUDFIRM	0.732	1.000	0.443	0.000	1.000
TENURE	5.910	7.000	1.873	5.000	7.000
CSOWN	0.354	0.324	0.182	0.213	0.490
CSTYPE	0.433	0.000	0.496	0.000	1.000
MOWN	0.081	0.003	0.148	0.000	0.080
RISK	9.320	9.206	1.762	8.027	10.442
DAC	0.080	0.050	0.101	0.023	0.102
PMDAC	0.074	0.051	0.077	0.023	0.097

Where: *MVE* is year-end market value of common shareholder's equity as at three month after the closing date, scaled by the beginning number of shares; *RET* is share return measured for twelve-months extending from nine months prior to the fiscal year through three months after the fiscal year-end calculated by natural logarithm of Share Price Year *t* scaled to Share Price year *t-1*; *Q* is approximation of Tobin's *Q*; *ΔEPS* is firm's earnings before extraordinary items per share in year *t* minus earnings before extraordinary items per share in year *t-1*, scaled by the beginning share price; *EPS* is earnings before extraordinary items per share, scaled by the beginning share price; *BVE* is year-end book value of common equity, scaled by the beginning number of shares; *EARN* is year-end income before extraordinary, scaled by the beginning number of shares; *GROWTH_{it}* is the previous year's growth, calculated based on market value of the firm at the end of year *t-1* divided by the ending book value of the total assets at *t-1*; *FSIZE* is natural logarithm of total assets; *DEBT* is a ratio of total debt to total assets; *BSIZE* is a board size based on actual members of the board of directors; *BDIND* is a proportion of independent non-executive directors to total board members; *ACIND* is a proportion of independent non-executive members to total members of the audit committee; *AOPIN* is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; *AUDFIRM* is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; *TENURE* is an actual tenure of auditor and client engagement; *CSOWN* is a percentage of ownership belongs to the controlling shareholder; *CSTYPE* is an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; *MOWN* is a percentage of managerial ownership; *RISK* is an operating risk measured based on three years earnings standard deviation; *DAC* is an absolute discretionary accruals based on Modified Jones Model (1995); *PMDAC* is an absolute performance matched discretionary accruals based on Kothari Model (2005). All variables are winsorised at the top and the bottom at 1%.

Table 7.2 also shows that the corporate governance variable *BSIZE* in our sample has an average of nine members (as does the median). The mean (median) of *BDIND* is 0.429

(0.400), and the mean (median) of *ACIND* is 0.906 (1.000). The statistics suggest that on average, listed firms in our sample have 42.9 percent (40 percent) of independent non-executive directors, and 90.6% (100 percent) membership of the audit committee. The mean (median) of *AOPIN* is 0.959 (1.000), *AUDFIRM* is 0.732 (1.000), and *TENURE* is 5.91 (7.000). On average, the listed firms in our sample received an unqualified audit opinion, of which 73.2 percent are audited by a Big 4 audit firm. The *TENURE* suggests that the listed firms retained the same auditor for six years.

On average, controlling shareholders (*CSOWN*) held about 35.4 percent of the equity ownership with the median being 32.4 percent, where on average, 43.3 percent of them are individuals or family groups. At this level of ownership, the controlling shareholders are predicted to entrench the minority shareholder's interests. The statistics also show that managerial ownership is low with the mean (median) being 8.1 percent (0.3 percent) of the equity ownership of firms. Finally, this study also includes *DAC* or *PMDAC* as a control variable in these firm valuation models. The *DAC* variable has a mean value of 0.080 and a median of 0.050 with a standard deviation 0.077, while the *PMDAC* has a mean (median) of 0.074 (0.51). The mean suggests that the managers or controlling shareholders may manage the discretionary accruals of the firm at almost 10 percent of the beginning total assets.

7.2.2 Correlation and Multicollinearity

Table 7.3A presents a Pearson's correlation matrix for Tobin's *Q* and earnings informativeness models. The Pearson's correlation matrix suggests that there is no indication that an unreasonably high correlation is present among the independent variables. The highest correlation is *EPS* and changes in *EPS* (ΔEPS), which the coefficient is 0.59,

and the second highest is *BDSIZE* and *FSIZE* (0.48). The third highest correlations are between *DEBT* and *FSIZE*, and *AFIRM* and *FSIZE*, which the coefficient of both correlations is 0.34. A high coefficient is expected for those correlations. The result of the Pearson's correlation matrix of the earnings-market valuation model is presented in Table 7.3B. The first two highest correlations are *EARN* and *BVE* (the coefficient is 0.47), and *BDSIZE* and *SIZE* (the coefficient is 0.48) as expected. The next two highest correlations are between *BSIZE* and *FSIZE*, and between *DEBT* and *BSIZE*, which both correlations have a coefficient 0.34. The other correlations among independence variables are reasonable that suggesting there is no multicollinearity issue.

This study repeats the correlation assessment using the non-parametric test, Spearman's correlation matrix, and finds that the correlations are consistent and robust. It agrees with Farrar and Glauber (1967) who suggests a harmful level of multicollinearity is not present until the correlation coefficient reaches 0.8. However, this study is concerned that the correlations of *EPS* and ΔEPS , and *BVE* and *EARN* are high. Thus, this issue will be reviewed again using Variance Inflation Factor (*VIF*) analysis. Kennedy (1998) and Street and Bryant (2000) suggest *VIF* of more than 10 indicates harmful collinearity.

Table 7.3A Pearson's Correlation Matrix (Tobin's Q and Share Return)

	EPS	ΔEPS	RPT	RP complex	RP simple	ΔRPT	ΔRP complex	ΔRP simple	GROWTH	SIZE	DEBT	AOPIN	AUDFIRM	TENURE	BSIZE	BDIND	ACIND	CSOWN	CSTYPE	MOWN
EPS																				
ΔEPS	0.48*																			
RPT	-0.06	0.01																		
RP complex	-0.06	0.00	0.90*																	
RP simple	-0.02	0.03	0.50*	0.13*																
ΔRPT	-0.01	-0.05	0.40*	0.29*	0.34*															
ΔRP complex	-0.02	-0.07	0.08*	0.10*	-0.04	0.55*														
ΔRP simple	0.01	0.03	0.29*	0.04	0.64*	0.62*	-0.02													
GROWTH	0.11*	-0.02	0.05	0.00	0.12*	0.00	0.00	0.02												
SIZE	0.12*	0.02	0.00	-0.03	0.01	0.01	-0.01	0.02	0.04											
DEBT	-0.03	-0.03	0.00	-0.04	0.08	0.02	-0.01	0.03	-0.03	0.34*										
AOPIN	0.04	-0.08	0.05	0.03	0.05	0.02	0.00	0.02	0.05	0.05	-0.02									
AUDFIRM	0.06	0.04	0.04	0.03	0.07	-0.02	-0.03	0.02	0.05	0.34*	0.10*	0.06								
TENURE	0.09*	0.04	-0.03	-0.02	-0.03	0.01	0.02	-0.02	0.02	0.18*	0.04	0.05	0.33*							
BSIZE	0.07	0.01	0.24*	0.19*	0.15*	0.04	0.01	0.07	0.06	0.48*	0.17*	0.07	0.18*	0.08*						
BDIND	-0.04	-0.02	-0.2*	-0.20*	-0.10*	-0.03	0.00	-0.05	0.03	-0.02	-0.01	-0.01	-0.05	-0.04	-0.4*					
ACIND	0.03	0.02	0.12*	0.10*	0.10*	0.03	0.00	0.05	0.01	0.11*	0.11*	0.05	0.05	-0.05	0.18*	0.26*				
CSOWN	0.04	-0.02	0.02	0.06	-0.05	0.02	0.01	-0.02	0.09*	0.20*	-0.01	0.11*	0.15*	0.03	0.06	-0.05	-0.04			
CSTYPE	-0.05	0.00	-0.1*	-0.10*	-0.03	-0.02	0.00	0.00	-0.11*	-0.20*	-0.03	-0.06	-0.10*	-0.05	-0.2*	0.07	0.03	-0.10*		
MOWN	0.01	0.01	-0.03	-0.02	0.00	0.00	0.01	0.01	-0.09*	-0.10*	-0.01	0.04	-0.10*	-0.05	-0.04	-0.05	0.08	-0.10*	0.33*	
RISK	-0.04	0.07	-0.01	-0.01	0.01	0.02	0.01	0.04	-0.05	-0.10*	-0.07	-0.07	-0.04	-0.01	-0.07	0.01	-0.03	-0.04	0.13*	0.04
DAC	-0.01	-0.01	0.01	-0.01	0.03	0.02	0.03	-0.01	0.05	0.02	-0.04	0.01	0.02	0.03	0.05	-0.02	0.06	0.04	0.01	0.04

* denote significant at the 0.01 level (two-tailed). Year, Industry, and Country variables are not reported for succinctness, but there is no multicollinearity issue within these variables.

Table 7.3B
Pearson's Correlation Matrix (Earnings-Market Valuation)

	BVE	EARN	RPT	RP complex	RP simple	ΔRPT	ΔRP complex	ΔRP simple	GROWTH	SIZE	DEBT	AOPIN	AUDFIRM	TENURE	BSIZE	BDIND	ACIND	CSOWN	CSTYPE	MOWN
EARN	0.47*																			
RPT	0.13*	0.20*																		
RP complex	0.06	0.05	0.87*																	
RP simple	0.14*	0.20*	0.57*	0.21*																
ΔRPT	0.08*	0.14*	0.49*	0.34*	0.48*															
ΔRP complex	0.01	-0.10*	0.38*	0.45*	0.04	0.69*														
ΔRP simple	0.09*	0.16*	0.33*	0.06	0.66*	0.70*	0.01													
GROWTH	-0.05	-0.00	-0.01	-0.02	0.04	-0.02	-0.02	-0.01												
SIZE	0.51*	0.20*	0.10*	0.02	0.16*	0.03	-0.02	0.06	0.04											
DEBT	-0.01	0.05	0.06	-0.03	0.13*	0.03	-0.01	0.04	-0.03	0.33*										
AOPIN	0.07	0.03	0.02	0.01	0.03	0.03	0.04	0.04	0.01	0.04	-0.01									
AUDFIRM	0.19*	0.07	0.08*	0.06	0.12*	0.01	-0.01	0.03	0.05	0.33*	0.10*	0.06								
TENURE	0.15*	0.06	0.01	0.01	0.02	0.01	0.02	-0.01	0.02	0.18*	0.04	0.06	0.33*							
BSIZE	0.36*	0.12*	0.26*	0.22*	0.23*	0.09*	0.04	0.10*	0.06	0.48*	0.17*	0.07	0.19*	0.08*						
BDIND	-0.01	0.01	-0.11*	-0.14*	-0.05	-0.05	-0.03	-0.04	0.03	-0.02	-0.01	-0.01	-0.05	-0.04	-0.40*					
ACIND	0.00	0.01	0.10*	0.09*	0.09*	0.04	0.01	0.04	0.01	0.11*	0.11*	0.05	0.05	-0.05	0.18*	0.26*				
CSOWN	0.10*	0.03	0.01	0.03	-0.03	0.01	0.05	-0.03	0.09*	0.19*	-0.01	0.10*	0.15*	0.02	0.06	-0.06	-0.04			
CSTYPE	-0.11*	-0.05	-0.11*	-0.10*	-0.08*	-0.03	-0.05	-0.00	-0.11*	-0.23*	0.00	0.05	-0.14*	-0.04	-0.24*	0.07	0.02	-0.11*		
MOWN	-0.06	-0.01	-0.10*	-0.08*	-0.08*	-0.04	-0.03	-0.02	-0.09*	-0.12*	-0.01	0.04	-0.12*	-0.05	-0.04	-0.05	0.08	-0.12*	0.33*	
RISK	-0.04	-0.03	-0.09*	-0.10*	-0.02	-0.03	-0.04	0.00	-0.05	-0.07**	-0.05	-0.04	-0.05	-0.04	-0.05	0.01	-0.01	-0.02	0.08*	0.02
DAC	0.08*	0.03	-0.01	-0.02	-0.03	-0.00	-0.01	0.01	-0.11*	0.06	-0.03	-0.02	-0.02	-0.06	-0.09*	0.01	-0.00	0.03	0.08	-0.03

* denote significant at the 0.01 level (two-tailed). *Year, Industry, and Country* variables are not reported for succinctness, but there is no multicollinearity issue within these variables.

7.2.3 Heteroskedasticity

This study finds these three multivariate regressions for firm valuation models have significant heteroskedasticity problems as indicated by $Obs \cdot R^2$ (the value is enclosed in the multivariate tables). All multivariate regressions are repeated to adjust the t-statistics based on White's heteroskedasticity-consistent standard errors and covariance. The results for the Tobin's Q models are presented in Table 7.4A and Table 7. 4B, results of *MVE* models are presented in Table 7.5A and Table 7. 5B. Finally, the results for earnings informativeness models are shown in Table 7.6A and Table 7.6B.

7.3 Empirical Results for Firm Performance - Tobin's Q

This section discusses the multivariate regressions results highlighting the relationship between the dependent and independent variables. The dependent variable, Tobin's Q, is regressed against the independent variable, RP transactions and type of RP transaction. The regression also includes control variables that represent firm characteristics (*GROWTH*, *FSIZE*, *DEBT*, *RISK*, and *DAC*), corporate governance (*Bsize*, *BDIND*, *ACIND*, *CSOWN*, and *MOWN*), and audit quality (*AOPIN*, *FSIZE*, and *TENURE*). RP transactions are measured using both magnitude and abnormal RP transactions. Magnitude refers to amount number of RP transactions in US\$, while abnormal refers to changes in magnitude of the RP transactions. Positive abnormal RP transactions indicate increasing magnitude of the transactions and otherwise; negative abnormal indicates decrease in magnitude of RP transactions. The magnitude and abnormal RP transactions are scaled by the opening total assets. This study relocates the *Eq. 5.11* as below, which the descriptions and measurements of the variables are defined in section 5.6.2.

$$\begin{aligned}
Q_{i,t} = & \beta_0 + \beta_1 \sum_{ij} RPTYPE_{i,t} + \beta_2 GROWTH_{i,t} + \beta_3 FSIZE_{i,t} + \beta_4 DEBT_{i,t} + \beta_5 BDSIZE_{i,t} \\
& + \beta_6 BDIND_{i,t} + \beta_7 ACIND_{i,t} + \beta_8 AOPIN_{i,t} + \beta_9 AUDFIRM_{i,t} + \beta_{10} TENURE_{i,t} \\
& + \beta_{11} CSOWN_{i,t} + \beta_{12} CSTYPE_{i,t} + \beta_{13} MOWN_{i,t} + \beta_{14} RISK_{i,t} + \beta_{15} DAC_{i,t} \\
& + \beta_{16} \sum_{ij} Year_{i,t} + \beta_{17} \sum_{ij} Industry_{i,t} + \beta_{18} \sum_{ij} Country_{i,t} + \varepsilon_{i,t}
\end{aligned} \tag{Eq. 5.11}$$

7.3.1 Magnitude RP Transaction

This section documents the multivariate results for the effect of magnitude RP transactions and types of classification on firm valuation. The investigation uses a sample consisting of 408 firms with 1,191 observations. I present the regression results in Table 7.4A. The adjusted R^2 of Model 1 is 26.8% and the model assesses the importance of RP transactions in explaining the change in share price. A separation into small types of classifications may reduce the explanation model's power, but I find that the adjusted R^2 of Model 2, Model 3, and Model 4 are constant at 26.4%, 23.3%, and 26.3%, respectively. The results of White's tests show all models suffered from heteroskedasticity. The t-statistics are reported in Table 7.4A based on White's (1980) heteroskedasticity-consistent covariance matrix. The results of the VIF analysis reveal that all the models were free from multicollinearity problems (see Appendix VI). Model 1 in Table 7.4A shows that magnitude RP transactions have a negative coefficient, -0.891 ($t=-3.83$) and are significant at level $p<0.01$. Here the magnitude RP transactions are associated with Tobin's Q which suggests that hypothesis H2 should be accepted. It can be interpreted that the investors or shareholders may perceive the presence of RP transactions as increasing the potential for wealth expropriation. They discount the share price of a related party's firm and leads to poorer market performance.

Table 7.4A
The Effect of RP Transactions on Market Performance (Tobin's Q)
(Magnitude RP Transactions)

Variable	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>
Constant	-2.744***	-3.52	-2.657***	-2.89	-2.867***	-2.83	-2.796***	-3.19
<i>RPT</i>	-0.891***	-3.83						
<i>RP complex</i>			-0.671***	-5.18				
<i>RP simple</i>					-2.441***	-3.00		
<i>RP loan</i>							-1.531***	-3.31
GROWTH	0.803***	15.88	0.852***	15.23	0.970***	8.99	0.856***	14.57
FSIZE	0.273***	6.47	0.261***	4.99	0.250***	3.50	0.266***	5.33
DEBT	5.790***	11.00	6.011***	9.06	6.405***	6.21	6.086***	8.95
BSIZE	-0.050**	-2.321	-0.052**	-2.14	-0.054	-1.62	-0.056**	-2.49
BDIND	-0.550	-1.28	-0.708	-1.42	-0.987***	-2.55	-0.620	-1.45
ACIND	-0.638***	-5.72	-0.685***	-5.16	-0.709**	-3.72	-0.666**	-4.68
AOPIN	-0.099	-0.30	-0.068	-0.20	0.119	0.33	-0.090	-0.28
AUDFIRM	0.730***	7.88	0.755***	8.19	0.891***	7.21	0.773***	7.83
TENURE	0.039***	3.17	0.042***	2.62	0.048*	1.67	0.043***	2.63
CSOWN	0.678**	2.56	0.783***	2.83	0.711*	1.68	0.711**	2.32
CSTYPE	-0.656***	-10.57	-0.636***	-9.11	-0.657***	-6.54	-0.649***	-8.49
MOWN	0.836	1.56	0.604	1.51	0.877	1.54	0.961	1.53
RISK	0.020	0.37	0.025	0.44	0.047	0.77	0.033	0.59
DAC	3.284***	2.61	3.149**	2.46	2.963***	2.55	3.103***	2.53
<i>Year</i>	Included		Included		Included		Included	
<i>Industry</i>	Included		Included		Included		Included	
<i>Country</i>	Included		Included		Included		Included	
<i>Adjusted R²</i>	26.8%		26.4%		24.2%		26.3%	
<i>Observations</i>	1,191		1,191		1,191		1,191	
<i>Obs*R²</i>								
<i>(White, 1980)</i>	528.5***		508.2***		442.8***		468.2***	

where: Q_{it} is approximation of Tobin's Q from the Eq. 1; *RPTYPE* represents one of the following vectors describing a magnitude RP transactions (RPT), RP complex, RP simple, or RP loan, scaled by the beginning total assets; $GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $FSIZE_{it}$ is natural logarithm of total assets; $DEBT_{it}$ is a ratio of total debt to total assets; $BSIZE_{it}$ is a board size based on actual numbers of directors; $BDIND_{it}$ is a proportion of independent non-executive directors to total board members; $ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$ is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; $AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$ is an actual tenure of auditor and client engagement; $CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise; $MOWN_{it}$ is a percentage of managerial ownership; $RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} is absolute discretionary accruals based on Modified Jones Model (1995); *Year* is a vector of year indicator variables 2008, 2009 and 2010; *Industry* is a vector of industry indicator variables based on the GICS industry classification; *Country* is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. *Year*, *industry*, and *country* variables are not reported for brevity.

The coefficients of a firm's characteristic control variables, *GROWTH* (0.803), *FSIZE* (0.273), *DEBT* (5.790), and *DAC* (3.284) are positively associated with *Q* and significant at level $p < 0.01$, while *RISK* (-0.020) is not significant. These associations of firm attributes are consistent with the prediction. The coefficients of corporate governance control variables like *BSIZE* (-0.050), *ACIND* (-0.638), and *CSTYPE* (-0.656) are negatively associated with *Q*. Control variables, *AFIRM* (0.730), *TENURE* (0.039) and *CSOWN* (0.678) have a positive relationship to *Q*, significant at level $p < 0.01$ (*AFIRM* and *TENURE*) and at $p < 0.05$ (*CSOWN*). Similarly, these associations are consistent with the prediction, except *ACIND* which shows that the independent audit committee does not improve firm performance. Other variables, *BDIND*, *AOPIN*, *MOWN* and *RISK* are insignificant.

I execute three separate multivariate regressions for each type of RP transactions. This analysis explores a differential impact of magnitude RP complex, RP simple, and RP transactions on a firm's market performance. The results appear in Model 2, Model 3, and Model 4 in Table 7.4A. The t-statistics are also reported based on White's (1980) heteroskedasticity-consistent covariance matrix. In Model 2, the coefficient of RP complex is -0.671 ($t = -5.18$) which means there is a negative association with *Q* and significant at level $p < 0.01$. The negative relationship suggests that the magnitude RP complex reduces a firm's market performance. This finding suggests accepting the hypothesis H2a. The results in Model 3 show that the coefficient of RP simple is -2.441 ($t = -3.00$), statistically significant at level $p < 0.01$. This evidence indicates that RP simple negatively affects Tobin's *Q*, which suggests accepting the hypothesis H2b. The coefficient also shows that the effect of RP simple is more severe than RP loan. A separate test of RP loan from the RP

simple shows a negative relationship between RP loan and Tobin's Q . The coefficient is -1.531 ($t=-3.31$), significant at level $p<0.01$. This suggests rejecting null hypothesis H2c because the evidence shows that market participants are very much aware of a company's use of RP loan.

These results suggest that the negative valuation of magnitude RP transaction is attributable to all types of RP transaction - RP complex, RP simple and RP loan. It also suggests that investors and shareholders differentiate the impact of each transaction type on a firm's valuation. Model 2, Model 3, and Model 4 in Table 7.4A show that the relationships between control variables and Q are consistent with the base Model 1. The coefficients for the firm's characteristics control variables, *GROWTH*, *FSIZE*, *DEBT*, and *DAC*, are positive and consistent with the prediction; however, *RISK* is insignificant in all models. The coefficients for governance control variables *BSIZE*, *ACIND* and *CSTYPE* are negative, and significantly associated with Q . The variables *AUDFIRM*, *TENURE* and *CSOWN* are significant and have a positive association with Q . *BDIND* is positive and significant at level $p<0.05$ in Model 3; *BSIZE* is not significant in Model 3. I find *MOWN* is not significant in all models.

7.3.2 Abnormal RP Transactions

The impact of RP transactions and their classifications on Tobin's Q were investigated through the abnormal (magnitude changes) of the transaction. The investigation uses a same sample consisting of 409 firms with 1,191 observations. The results are presented in Table 7.4B. The VIF analysis confirms that models are free of multicollinearity problems among

the variables (see Appendix VII). The t-statistics are reported based on White's (1980) heteroskedasticity-consistent covariance matrix. In Table 7.4B, Model 1 shows the adjusted R^2 is 31.5%, which indicates the model could assess the importance of RP transactions in explaining the change in market performance. The coefficient of the abnormal RP transaction is negative (-0.536) but is insignificant, showing no association between abnormal RP transactions and Tobin's Q . The result indicates that abnormal RP transactions do not affect a firm's performance, which suggests accepting the null hypothesis H2.

Table 7.4B reveals that the control variables *GROWTH* (1.022), *FSIZE* (0.241), *DEBT* (6.507), *AUDFIRM* (0.893), *TENURE* (0.059), *CSOWN* (0.856), and *DAC* (3.017) have a positive relationship to Tobin's Q . These coefficients are significant at level $p < 0.01$ except *CSOWN*, which is significant at level $p < 0.05$. These associations are consistent with the predictions. In contrast, *BSIZE* (-0.051), *BDIND* (-1.051), *ACIND* (-0.621) and *CSTYPE* (-0.711) are negatively associated with Tobin's Q . Other control variables, *AOPIN* and *RISK*, are insignificant.

I repeat the multivariate regression by substituting RP transaction type to explore the differential effect in market performance with an alternative measurement, i.e. abnormal RP transactions. The results are shown in Model 2, Model 3, and Model 4 in Table 7.4B. Table 7.4B shows that the adjusted R^2 of each model is 22.8%, 26.3%, and 26.5%, respectively in explaining the associations. In Model 2, I find that the abnormal RP complex is negative (-5.265) but insignificant. This result suggests rejecting the hypothesis, H2a which proposes a

negative association between RP complex and Tobin's Q . It implies investors perceive the abnormal RP complex as not influencing a firm's marketplace performance.

Model 3 shows the coefficient of abnormal RP simple is negative (-0.669; t value=-1.97), associated with Tobin's Q , and significant at level $p < 0.05$. This result implies that the abnormal RP simple has a negative relationship with Tobin's Q , which is consistent with the magnitude suggesting that investors perceive RP simple is more severe than RP complex. I further investigate RP loan by executing separate multivariate regression from RP simple. The result in Model 4 of Table 7.4B exhibits a negative coefficient (-1.022; t value=-1.94), and is statistically significant at level $p \leq 0.05$. The negative association between RP loan and Tobin's Q indicates that a firm's involvement in RP loan weakens its market performance. These results suggest rejecting the null hypotheses H2b and H2c, but accepting a null hypothesis H2a. These relationships imply that investors value the abnormal RP simple as being more severe than RP complex, specifically for the RP loan. Investors or shareholders worry that a straight-forward transaction with related parties, including a loan arrangement, may be used opportunistically to expropriate wealth from the firms. This is indicated by a company's poorer market valuation when it is manipulating RP simple and RP loan.

The control variables in each model have a similar association as indicated in the base Model 1. The following variables, *GROWTH*, *FSIZE*, *DEBT*, *AFIRM*, *TENURE*, *CSOWN*, *MOWN* and *DAC*, have a positive association with Tobin's Q . Control variables *BSIZE*, *BDIND*, *ACIND* and *CSTYPE* are negatively associated with Tobin's Q , while *AOPIN* and *RISK* are insignificant. However, *ACIND* is not significant in Model 2 and *BDIND* is not significant

in Model 3 and Model 4. These results support differentiating the types of RP transaction. Consistent with magnitude, the abnormal RP transactions suggest that RP simple, specifically RP loan substantially contributes to the negative relationship between RP transactions and the firm's poorer market performance. The coefficients also provide information that the effect of RP complex, RP simple, and RP loan does emphasize the level of harm.

Table 7.4B
The Effect of RP Transactions on Market Performance (Tobin's Q)
(Abnormal RP Transactions)

Variable	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
	Coefficient	t-stat	coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constant	-3.013***	-2.60	-5.283**	-2.51	-2.797***	-3.14	-2.839***	-3.23
ΔRPT	-0.536	-0.31						
ΔRP complex			-5.265	-0.64				
ΔRP simple					-0.669**	-1.97		
ΔRP loan							-1.022**	-1.94
GROWTH	1.022***	7.09	3.124***	5.16	0.855***	14.55	0.853***	14.62
FSIZE	0.241***	3.52	0.231**	2.14	0.270***	5.27	0.257***	5.27
DEBT	6.507***	6.22	6.045***	3.61	6.020***	8.93	6.079***	9.77
BSIZE	-0.051*	-1.70	-0.045*	-1.65	-0.057**	-2.58	-0.055***	-2.66
BDIND	-1.051***	-2.70	-2.795***	-19.45	-0.619	-1.39	-0.661	-1.49
ACIND	-0.621***	-2.14	-0.038	-0.12	-0.691***	-4.44	-0.620***	-3.89
AOPIN	0.009	0.03	0.267	0.66	-0.097	-0.30	-0.085	-0.27
AUDFIRM	0.893***	8.37	0.626***	4.76	0.765***	7.73	0.781***	8.80
TENURE	0.059***	1.89	0.153**	2.46	0.042**	2.50	0.046***	2.75
CSOWN	0.856**	2.21	1.322**	2.00	0.711**	2.45	0.787**	2.95
CSTYPE	-0.711***	-7.39	-0.777***	-4.56	-0.650***	-8.35	-0.659***	-9.66
MOWN	1.312*	1.47	1.805**	1.99	0.974	1.55	0.937	1.51
RISK	0.055	0.78	0.105	0.91	0.032	0.55	0.031	0.50
DAC	3.017***	3.02	1.402***	3.45	3.145***	2.64	4.400***	4.42
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	24.3%		22.8%		26.3%		26.5%	
Observations	1,191		1,191		1,191		1,191	
Obs*R ² (White, 1980)	404.5***		369.2***		446.4****		491.9***	

where: Q_{it} is approximation of Tobin's Q from the Eq. 1; $RPTYPE$ represents one of the following vectors describing a abnormal RP transactions (RPT), ΔRPT , ΔRP complex, ΔRP simple and ΔRP loan, scaled by the beginning total assets; $GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $FSIZE_{it}$ is natural logarithm of total assets; $DEBT_{it}$ is a ratio of total debt to total assets; $BSIZE_{it}$ is a board size based on actual numbers of directors; $BDIND_{it}$ is a proportion of independent non-executive directors to total board members; $ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$ is an indicator variable equal to one if the auditor issued clean audit opinion, and

zero otherwise; $AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$ is an actual tenure of auditor and client engagement; $CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise; $MOWN_{it}$ is a percentage of managerial ownership; $RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} is absolute discretionary accruals based on Modified Jones Model (1995); $Year$ is a vector of year indicator variables 2008, 2009 and 2010; $Industry$ is a vector of industry indicator variables based on the GICS industry classification; $Country$ is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. *Year*, *industry*, and *country* variables are not reported for brevity.

Table 7.4A and Table 7.4B show that control variable, DAC is positive and significantly associated with Tobin's Q . The interpretation of the results is consistent with signaling mechanism (Bartov, Givoly, & Hayn, 2002; Chaney & Lewis, 1995; Hunt, Moyer, & Shevlin, 1997; Ronen & Sadan, 1980; Wang & William, 1994). It may also cause by efficient contracting suggested by Christie and Zimmerman (1994). These studies documents signaling evidence of earnings management to facilitate efficient communication between managers and information users to improve the value relevance of financial reporting and, to enhance investors' ability in predicting firms' performance. Dye (1988) stated that through a smoother make an income stream more predictable, which could influence prospective investors' perceptions of firm value. Theoretically, earnings management arises from two competing perspectives, information asymmetry problem and agency conflicts, where the managers have a comparative information advantage over shareholders.

Under agency conflict perspective, the market imperfections create an environment for managers to engage in accounting discretion to promote their self-interest at the expense of shareholders. However, under information asymmetry perspective, they also create an opportunity for managers to use accounting discretion to communicate their companies' performance-related information in an appropriate manner with investors (Trueman &

Titman, 1988). Managers may be able to affect the stock price by engaging in earnings management that could create a smooth and growing earnings string over time (Sun & Rath, 2008). This result indicates a possibility that managers manage earnings to convey their inside information about firm's prospects, and thus it serves as a signaling mechanism to communicate inside information from the management to the investors.

Besides that, Christie and Zimmerman (1994) linked certain earnings management can be motivated by efficient contracting purpose. They define discretionary accruals as efficient if it could facilitate internal control and decision making, including monitoring managers, limit opportunism, minimize taxes, reduce costly debt covenant renegotiations, and minimize contracting costs. Christie and Zimmerman (1994) that investigate the frequency of acquired firms engage in earnings management to maximize reported earnings, find that the discretions are not used to avoid a possible takeover. Thus, they conclude that earnings management for contracting purpose is not as opportunistic. Subramanyam (1996) also provides evidence that showing the stock market reacts positively to discretion of earnings via accruals. They interpret that management discretionary behaviors through accruals increase earnings persistence, and thus improve the ability of current earnings in signaling future firm's prospect.

7.4 Empirical Results for Earnings-Market Valuation

This section documents the results of the multivariate regression between RP transactions and firm valuation as measured by market value of equity. The regressions use a sample consisting of 1,191 observations. RP transactions are also measured using magnitude and

abnormal RP transactions. The multivariate regression is executed by using Eq. 5.13 which includes RP transactions representing testing value-relevant information. The separate regressions are executed by substituting the testing variable with the RP complex, RP simple, or RP loan. The multivariate equation is as follows:

$$\begin{aligned}
MVE_{i,t} = & \beta_0 + \beta_1 BVE_{i,t} + \beta_2 EARN_{i,t} + \beta_3 \sum_{ij}^8 RPTYPE_{i,t} + \beta_4 BVE_{i,t} * \sum_{ij}^8 RPTYPE_{i,t} \\
& + \beta_5 EARN_{i,t} * \sum_{ij}^8 RPTYPE_{i,t} + \beta_6 GROWTH_{i,t} + \beta_7 FSIZE_{i,t} + \beta_8 DEBT_{i,t} \\
& + \beta_9 BDSIZE_{i,t} + \beta_{10} BDIND_{i,t} + \beta_{11} ACIND_{i,t} + \beta_{12} AOPIN_{i,t} + \beta_{13} AUDFIRM_{i,t} \\
& + \beta_{14} TENURE_{i,t} + \beta_{15} CSOWN_{i,t} + \beta_{16} CSTYPE_{i,t} + \beta_{17} MOWN_{i,t} + \beta_{18} RISK_{i,t} \\
& + \beta_{19} DAC_{i,t} + \beta_{20} \sum_{ij}^3 Year_{i,t} + \beta_{21} \sum_{ij}^4 Industry_{i,t} + \beta_{22} \sum_{ij}^4 Country_{i,t} + \varepsilon_{i,t}
\end{aligned}$$

Eq. 5.13

7.4.1 Magnitude RP Transactions

The multivariate regression results are presented in Table 7.5A. The adjusted R^2 of Model 1 is 69.1%. The model substantially assesses the importance of RP transactions in explaining the change in market value of equity. The t-statistics are based on White's (1980) consistent estimator since the estimation suffers from heteroskedasticity. In Model 1, I find the coefficient of RP transactions is negative (-0.237; $t=-2.13$), significant at level $p<0.05$. It illustrates the magnitude RP transactions negatively associated with *MVE* and in turn reduces a company's valuation. The result also shows an interaction between magnitude RP transactions and earnings (*RPT*EARN*) has a negative weighting (-2.153; $t=-4.67$) and significant at level $p<0.01$. This finding suggests that magnitude RP transactions reduce earnings value relevance. Meanwhile, an interaction between magnitude RP transactions and book value of equity (*RPT*BVE*) has a positive weighting (0.287; $t=3.24$) and is also

significant at level $p < 0.01$. This suggests that investors value magnitude RP transactions when the book value of the common equity increases. These results are consistent with Kohlbeck and Mayhew (2010).

Model 1 also shows that *EARN* (4.569) and *BVE* (0.606) have a positive relationship to *MVE*, where the relationship is consistent with earnings value relevance (Ohlson, 1995; Barth et al., 1998). The firm's attributes control variables, *GROWTH* (0.266) and *DEBT* (1.030) have a positive association with *MVE*, and are significant at level $p < 0.01$. However, *DAC* (-0.369) is negatively associated with *MVE*, while *FSIZE* and *RISK* are not significant. The corporate governance attributes, *BSIZE* (0.072), *BDIND* (0.340), *AOPIN* (0.062), *AUDFIRM* (0.172), and *CSOWN* (0.147) are significantly associated with *MVE*. The *TENURE* (-0.009), *ACIND* (-0.936), and *CSTYPE* (-0.122) are negatively associated with *MVE*. The *TENURE* and *CSTYPE* are significant at level $p < 0.01$, while the *CSOWN* is significant at level $p < 0.05$. These associations are consistent with the prediction. Other control variables representing firms and their governance characteristics are insignificant. Based on these findings, this study accepts hypothesis H2 which posits a negative association between RP transactions and firm market valuation.

Table 7.5A also presents results for the effect each type of RP transaction on *MVE*, as shown in Model 2, Model 3, and Model 4. The adjusted R^2 of these three models is consistent at 66.4%, 69.1%, and 68.4%, respectively. According to these models, I find that magnitude RP complex and RP simple have a negative weighting and significant at level $p < 0.01$, where the coefficient is -0.315 ($t = -1.82$) and -0.656 ($t = -2.57$), respectively. I also find that the

coefficient of *RP loan* is -1.969 ($t=-2.73$), negative and statistically significant at level $p<0.01$. These results show that magnitude *RP complex*, *RP simple* and *RP loan* transactions are associated with a firm's lower market valuation. The coefficients of *RP complex*EARN* (-0.278), *RP simple*EARN* (-4.97) and *RP loan*EARN* (-1.549) significant at level $p<0.01$, are negatively associated with *MVE*. These associations show that interactions between magnitudes *RP complex*, *RP simple* or *RP loan* and earnings affect reducing earnings value relevance. I also find interactions between *RP complex*BVE*, *RP simple*BVE*, and *RP loan*BVE* have a positive association with *MVE*. The coefficients are 0.039, 0.841, and 0.321 respectively, and statistically significant at level $p<0.01$. These results suggest that the magnitude of each type of *RP* transaction increases market valuation of the book value of equity.

Model 2, Model 3, and Model 4 in Table 7.5A also show that control variables, *GROWTH*, *DEBT*, *BSIZE*, and *AUDFIRM* have positive associations with *MVE*. They are significant at level $p<0.01$. In contrast, *ACIND*, *CSTYPE* and *DAC* are negatively associated with *MVE*; the coefficients are significant at level $p<0.01$. The coefficients of *FSIZE*, *TENURE*, *MOWN* and *RISK* are not significant in all models. It is a concern that the correlations between *BVE* and *EARN*, and between *BSIZE* and *FSIZE* are considered high (see section 7.3). Therefore, I use VIF analysis to confirm there is no multicollinearity problem. The outcome shows that the *VIF* for all variables are less than 5.00, which confirms there is no multicollinearity problem within these variables (see Appendix VI).

Table 7.5A
The Effect of RP Transactions on Earnings-Market Valuation (MVE)
(Magnitude RP Transactions)

	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
Variable	Coefficient	t-stat	Coefficient	t-stat	coefficient	t-stat	coefficient	t-stat
Constant	-0.388	-0.65	-0.583	-0.93	-0.429	-0.70	-0.516	-0.84
BVE	0.606***	5.42	0.568***	4.15	0.616**	5.54	0.641***	5.94
EARN	4.569***	9.02	4.144***	5.90	4.557***	9.24	4.085***	7.21
RPT	-0.237**	-2.13						
RPT*BVE	0.287***	3.24						
RPT*EARN	-2.153***	-4.67						
RP complex			-0.315*	-1.82				
RP complex*BVE			0.039***	6.34				
RP complex*EARN			-0.278***	-5.93				
RP simple					-0.656***	-2.57		
RP simple*BVE					0.841***	4.99		
RP simple*EARN					-4.97***	-5.23		
RP loan							-1.969***	-2.73
RP loan*BVE							0.321***	2.63
RP loan*EARN							-1.549***	-7.59
GROWTH	0.266***	2.87	0.265***	2.86	0.268***	2.87	0.269***	2.84
FSIZE	-0.016	-0.50	0.003	0.08	-0.010	-0.32	-0.002	-0.05
DEBT	1.030***	6.56	0.773***	16.26	1.007***	6.64	0.964***	5.44
BSIZE	0.072***	7.60	0.079***	8.42	0.066***	8.58	0.067***	11.80
BDIND	0.340***	2.62	0.295*	1.81	0.361***	3.20	0.328**	2.10
ACIND	-0.936***	-8.58	-0.933***	-7.83	-0.997***	-9.41	-0.960***	-8.26
AOPIN	0.062**	1.99	0.061	1.27	0.056**	2.11	0.071*	1.77
AUDFIRM	0.172***	35.10	0.184***	9.97	0.170***	44.41	0.177***	48.20
TENURE	-0.009	-2.63	-0.013*	-1.88	-0.006	-0.98	-0.007	-1.38
CSOWN	0.147**	2.37	-0.210***	3.55	0.166***	3.84	0.149***	6.63
CSTYPE	-0.122***	-4.72	-0.116***	-3.26	-0.130***	-4.72	-0.121***	-3.45
MOWN	0.064	0.90	0.057	0.58	0.116	1.42	0.074	0.66
RISK	0.002	0.06	0.010	0.43	0.004	0.16	0.004	0.14
DAC	-0.369**	-3.92	-0.566**	-2.22	-0.289*	-1.94	-0.304*	-1.83
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	69.1%		66.4%		69.1%		68.4%	
Observations	1,191		1,191		1,191		1,191	
Obs* R ² (White, 1980)	1,017.2***		1,032.9***		1,021.0***		1,024.6***	

where: MVE_{it} , is market value of common shareholder's equity as at three month after the closing date, scaled by the beginning number of shares outstanding; BVE_{it} , is year-end book value of common equity, scaled by the beginning number of shares outstanding; $EARN_{it}$, is year-end income before extraordinary, scaled by the beginning number of shares outstanding; $RPTYPE_{it}$, represents one of the following vectors describing a magnitude RP transactions (RPT), RP complex, RP simple, or RP loan, scaled by the beginning number of shares; $GROWTH_{it}$, is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $DEBT_{it}$, is a ratio of total debt to total assets; $BSIZE_{it}$, is a board size based on actual numbers of directors; $BDIND_{it}$, is a proportion of independent non-executive directors to total board members; $ACIND_{it}$, is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$, is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; $AUDFIRM_{it}$, is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$, is an actual tenure of auditor and client engagement; $CSOWN_{it}$, is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$, is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise; $MOWN_{it}$, is a percentage of managerial ownership; $RISK_{it}$, is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} , is discretionary accruals based on Modified Jones Model (1995); $Year$ is a vector of year indicator variables 2008, 2009 and 2010; $Industry$ is a vector of industry indicator variables based on the GICS industry classification; $Country$ is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. *Year*, *industry*, and *country* variables are not reported for brevity.

These findings can be interpreted as follows. Investors and shareholders perceive the magnitude RP complex, RP simple and RP loan transactions will likely be used to expropriate wealth from businesses. However, differentiation exists within each type of RP transaction. Investors may recognize the potential of such transactions to be harmful depending on the nature of the transactions. The weighting coefficients show that the market value of the magnitude RP simple is slightly more severe than RP complex in reducing firm valuation. The results also show that RP simple reduces earnings value relevance compared to RP complex.

7.4.2 Abnormal RP Transactions

I repeat all the multivariate regressions in 7.4.1 by substituting magnitude with abnormal RP transactions. This study uses the same sample consisting of 1,191 observations, and the results are presented in Table 7.5B. The t-statistics are based on White (1980) which is a consistent estimator in the presence of heteroskedasticity. Model 1 shows that the adjusted R^2 is 70.4% in explaining the model. The adjusted R^2 of Model 2, Model 3, and Model 4 are

found to be stable at the level 71.3%, 67.4%, and 69.0%, respectively. The results of the VIF analysis show that the VIF for all the variables are less than 5.00, confirming there is no multicollinearity problem within the variables.

Model 1 in Table 7.5B shows the coefficient of abnormal RP transactions (ΔRPT) is negative (-1.065; $t=-2.05$) and significant at level $p<0.05$. This indicates that the abnormal RP transactions have a negative association with *MVE*, where changes in magnitude of RP transactions substantially reduce firm valuation. Model 1 also shows an interaction between abnormal RP transactions and earnings ($\Delta RPT*EARN$) has a negative coefficient (-2.687; $t=-2.79$) and is significant at level $p<0.01$. This finding implies that the abnormal RP transactions reduce earnings value relevance. Meanwhile, an interaction between abnormal RP transactions and book value of equity ($\Delta RPT*BVE$) has a positive coefficient (0.511; $t=2.36$) and is also significant at level $p<0.05$. It could mean that investors perceive abnormal RP transactions increase a valuation of the book value of common equity. These findings are consistent and support the earlier findings for magnitude that show RP transactions reduce firm valuation. These findings suggest of hypothesis H2 should be accepted.

Based on Model 1, I also find these control variables, *GROWTH* (0.561), *DEBT* (1.195), *Bsize* (0.060), *AUDFIRM* (0.132), *CSOWN* (0.173), and *MOWN* (0.253) have a positive and significant association with *MVE* at level $p<0.01$. In contrast, *ACIND* (-1.008), *CSTYPE* (-0.093), and *DAC* (-0.442) are negative, consistently associated with *MVE*, and significant at level $p<0.01$. The variable *AOPIN* is also positively associated with *MVE* but only

significant at level $p < 0.05$. These associations between *CSTYPE* and *MVE* may indicate the likelihood of entrenchment effect. Other control variables like *FSIZE*, *BDIND*, *TENURE* and *RISK* are insignificant. The associations among these control variables are consistent in Model 2, Model 3, and Model 4, except *MOWN* which is insignificant in Model 4.

Model 2, Model 3, and Model 4 present the results for the effect of ΔRP complex, ΔRP simple, and ΔRP loan transaction on market valuation. The t-statistics are based on White's (1980) consistent estimator. It is evident that ΔRP complex (-0.867 ; $t = -2.70$), ΔRP simple (-2.026 ; $t = -9.36$) and ΔRP loan (-1.646 ; $t = -2.15$) have a negative association with *MVE*, and is significant at level $p < 0.01$. These results suggest that the magnitude change of each RP transaction type reduces firm valuation. They also show that abnormal RP complex, RP simple and RP loan decreases earnings value relevance. The results are shown by the coefficients of ΔRP complex**EARN* (-4.643 ; $t = -4.29$) and ΔRP loan**EARN* (-6.817 ; $t = -2.69$), while ΔRP simple**EARN* (-2.026 ; $t = -2.23$), that represent interactions between abnormal RP complex, RP simple, or RP loan and earnings. Consistent with the Model 1, interactions between abnormal RP complex, RP simple or RP loan and *BVE* are positively associated with *MVE*. The coefficients of ΔRP complex**BVE* and ΔRP loan**BVE* are 1.139 and 0.727, respectively, and are significant at level $p < 0.01$. I find that the interaction of ΔRP simple**BVE* is also significant (1.810) but only significant at $p < 0.10$. These results suggest that abnormal of RP complex, RP simple and RP loan increase the market value of the book value of common equity. These findings suggest accepting the hypotheses H2a, H2b and H2c which predict a negative association between those types of RP transactions.

Table 7.5B
The Effect of RP Transactions on Earnings-Market Valuation
(Abnormal RP Transactions)

Variable	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
	<i>Coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>
Constant	-0.55	-0.82	-0.717	-1.09	-0.319	-0.50	-0.407	-0.71
BVE	0.742***	6.25	0.709***	5.84	0.674***	6.70	0.636***	5.99
EARN	3.836***	5.60	3.555***	5.15	4.527***	9.21	4.259***	11.27
ΔRPT	-1.065**	-2.05						
$\Delta RPT*BVE$	0.511**	2.36						
$\Delta RPT*EARN$	-2.687***	-2.79						
ΔRP complex			-0.867***	-2.70				
ΔRP complex*BVE			1.139***	5.42				
ΔRP complex*EARN			-4.643***	-4.29				
ΔRP simple					-2.026***	-9.36		
ΔRP simple*BVE					1.810*	1.93		
ΔRP simple*EARN					-10.258**	-2.23		
ΔRP loan							-1.646**	-2.15
ΔRP loan*BVE							0.727***	2.65
ΔRP loan*EARN							-6.817***	-2.69
GROWTH	0.561***	2.82	0.525***	2.98	0.298***	2.63	0.267***	2.85
FSIZE	-0.013	-0.31	0.003	0.07	-0.022	-0.59	-0.008	-0.29
DEBT	1.195***	4.28	1.031***	5.04	1.122***	4.68	0.980***	6.35
BSIZE	0.060***	4.94	0.057***	5.63	0.075***	7.33	0.069***	10.41
BDIND	0.101	0.70	0.166	1.11	-0.063	-0.52	0.007	0.04
ACIND	-1.008***	-4.86	-0.924***	-5.88	-0.969***	-5.36	-0.828***	-6.26
AOPIN	0.053**	2.47	0.058**	2.25	0.056**	2.03	0.066**	2.03
AUDFIRM	0.132***	14.74	0.130***	36.46	0.166***	19.34	0.159***	11.39
TENURE	-0.006	-1.25	-0.006	-1.18	-0.007	-0.99	-0.006	-1.00
CSOWN	0.173***	4.43	0.166***	5.36	0.202***	3.75	0.149***	24.13
CSTYPE	-0.093***	-3.12	-0.101***	-3.20	-0.113***	-3.10	-0.121***	-3.59
MOWN	0.253***	2.81	0.172**	2.35	0.234*	-1.82	0.076	0.76
RISK	0.011	0.37	0.010	0.35	0.012	0.40	0.003	0.12
DAC	-0.442***	-3.95	-0.407***	-3.72	-0.335**	-2.24	-0.309**	-2.02
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	70.4%		71.3%		67.4%		69.0%	
Observations	1,191		1,191		1,191		1,191	
Obs*R ²								
(White, 1980)	994.3***		1,001.7***		976.1***		978.1***	

where: MVE_{it} , is market value of common shareholder's equity as at three month after the closing date, scaled by the beginning number of shares outstanding; BVE_{it} , is year-end book value of common equity, scaled by the beginning number of shares outstanding; $EARN_{it}$, is year-end income before extraordinary, scaled by the beginning number of shares outstanding; $RPTYPE_{it}$, represents one of the following vectors describing a magnitude change (abnormal), ΔRPT , ΔRP complex, ΔRP simple or ΔRP loan, scaled by the beginning number of shares outstanding; $GROWTH_{it}$, is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $FSIZE_{it}$, is natural logarithm of total assets; $DEBT_{it}$, is a ratio of total debt to total assets; $BSIZE_{it}$, is a board size based on actual numbers of directors; $BDIND_{it}$, is a proportion of independent non-executive directors to total board members; $ACIND_{it}$, is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$, is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; $AUDFIRM_{it}$, is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$, is an actual tenure of auditor and client engagement; $CSOWN_{it}$, is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$, is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise; $MOWN_{it}$, is a percentage of managerial ownership; $RISK_{it}$, is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} , is discretionary accruals based on modified Jones model (1995); $Year$ is a vector of year indicator variables 2008, 2009 and 2010; $Industry$ is a vector of industry indicator variables based on the GICS industry classification; $Country$ is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. $Year$, $industry$, and $country$ variables are not reported for brevity.

7.5 Empirical Results for Earnings Informativeness

The association between RP transactions and earnings informativeness is examined, and represented by an association with share return. RP transactions and types of RP transactions are measured using magnitude and abnormal RP transactions. This study uses Eq. 5.14 to examine the hypotheses by including an interaction variable between RP transactions and earnings ($EPS \times RPT$) to represent informativeness of earnings. Therefore I determine the effect of magnitude RP transaction on earnings informativeness using coefficient α_4 . The analyses use a sample that consists of 1,187 observations. The Eq. 5.14 is shown below where the variables and measurements were defined in Chapter 5.

$$\begin{aligned}
 RET_{it} = & \beta_0 + \beta_1 \Delta EPS_{it} + \beta_2 EPS_{it} + \beta_3 \Sigma_{ij}^8 RPTYPE_{it} + \beta_4 EPS_{it} * \Sigma_{ij}^8 RPTYPE_{it} \\
 & + \beta_5 GROWTH_{it} + \beta_6 FSIZE_{it} + \beta_7 DEBT_{it} + \beta_8 BDSIZE_{it} + \beta_9 BDIND_{it} \\
 & + \beta_{10} ACIND_{it} + \beta_{11} AOPIN_{it} + \beta_{12} AUDFIRM_{it} + \beta_{13} TENURE_{it} \\
 & + \beta_{14} CSOWN_{it} + \beta_{15} CSTYPE_{it} + \beta_{16} MOWN_{it} + \beta_{17} RISK_{it} + \beta_{18} DAC_{it} \\
 & + \beta_{19} \Sigma_{ij}^3 Year_{it} + \beta_{20} \Sigma_{ij}^4 Industry_{it} + \beta_{21} \Sigma_{ij}^4 Country_{it} + \varepsilon_{it}
 \end{aligned} \tag{Eq. 5.14}$$

I then execute separate multivariate regression by substituting the testing variable with RP complex, RP simple, or RP loan transactions. Table 7.6A displays the multivariate results of association between magnitude RP transactions and types of RP transactions, and earning informativeness, while Table 7.6B presents results for the abnormal. The t-statistics are based on White's (1980) consistent estimator in with heteroskedasticity being present. The *VIF* analysis confirms that the models' variables have no multicollinearity problem (see Appendix VI and Appendix VII).

7.5.1 Magnitude RP Transactions

Model 1 in the first column of Table 7.6A shows the adjusted R² is 58.3%, in which the model substantially assesses the importance of magnitude RP transactions in explaining the change in share returns. I find that α_4 , the coefficient of *RPT* EPS* is negative (-0.138; $t=-4.79$), and significant at level $p<0.01$. This shows that magnitude RP transactions have a negative relationship to share return (*RET*) and substantially reduce earnings informativeness. This further suggests accepting the hypothesis H2 that predicting magnitude RP transactions does negatively affect informativeness of earnings.

Model 1 of Table 7.6A also shows that associations between *EPS* and *RET* (0.086), and between ΔEPS and *RET* (0.086) are consistent with the prediction. The associations are statistically significant at level $p<0.01$. Control variables *FSIZE* (0.002) and *BSIZE* (0.009) have a positive relationship to *RET*, and are significant at level $p<0.10$, while *AUDFIRM* (0.026) and *CSTYPE* (0.021) are significant at level $p<0.05$. The *AOPIN* (0.146) also has a positive association with *RET* that is significant at level $p<0.01$. Both firm attributes -

DEBT (-0.182) and *RISK* (-0.015) - are negatively associated with *RET*, and significant at level $p < 0.05$ and $p < 0.10$. Other control variables representing firms and corporate governance characteristics are insignificant. These associations between control variables and share returns are consistent across Model 2, Model 3, and Model 4, except *FSIZE*. The attribute of earnings quality, *DAC* is only significant in Model 4.

The results of separate multivariate regressions that examine the effect of each RP transaction type are presented in Model 2, Model 3, and Model 4 in Table 7.6B. In Model 2 the coefficients of interaction between RP complex and earnings (*RP complex*EPS*) are negative but insignificant. This result indicates that RP complex has no association with share return, and suggests that a firm's involvement in RP complex does not affect earnings informativeness. Based on this evidence, I should reject the hypotheses H2a that predict a negative relationship. The results of Model 3 as shown in Table 7.6A, for the coefficient of interaction between *RP simple*EPS*, are negative (-0.151; $t = -4.47$) and significant at level $p < 0.01$. This shows that the magnitude of RP simple substantially reduces earnings informativeness.

In addition, the result for Model 4 shows that RP loan has a negative relationship with *RET*, where the coefficient is -0.106 ($t = -2.86$) significant at level $p < 0.01$. The coefficient of interaction between *RP loan*EPS* also has a negative relationship to *RET* (-0.376; $t = -4.28$), and is significant at level $p < 0.01$. These findings suggest that the firm's engagement in RP loan substantially reduces share return and leads to declining informativeness of earnings. This means that hypotheses H2b and H2c can be accepted.

Table 7.6A
The Effect of RP Transactions on Earnings Informativeness (RET)
(Magnitude RP Transactions)

Variable	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
	<i>Coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>Coefficient</i>	<i>t-stat</i>
Constant	-0.040	-0.11	-0.033	-0.10	-0.049	-0.14	-0.037	-0.11
ΔEPS	0.086***	5.45	0.088***	4.96	0.085***	5.64	0.102***	7.29
EPS	0.259***	7.19	0.231***	5.64	0.251***	7.17	0.236***	5.60
<i>RPT</i>	0.072	1.15						
<i>RPT*EARN</i>	-0.138***	-4.79						
<i>RP complex</i>			0.119	1.32				
<i>RP complex*EARN</i>			-0.111	-1.27				
<i>RP simple</i>					-0.078	-0.88		
<i>RP simple*EARN</i>					-0.151***	-4.47		
<i>RP loan</i>							-0.106***	-2.86
<i>RP loan*EARN</i>							-0.376***	-4.28
<i>GROWTH</i>	-0.020***	-2.79	-0.020***	-2.79	-0.019***	-2.75	-0.066**	-2.03
FSIZE	0.002*	0.07	0.002	0.06	0.003	0.10	0.004	0.16
DEBT	-0.182**	-2.37	-0.186***	-2.44	-0.188**	-2.52	-0.229***	-4.09
BSIZE	0.009*	1.92	0.009*	1.81	0.009**	2.03	0.010**	2.34
BDIND	-0.003	-0.04	-0.010	-0.10	-0.012	-0.12	0.011	0.11
ACIND	0.017	0.29	0.019	0.29	0.020	0.31	0.017	0.27
AOPIN	0.146***	3.40	0.147***	3.45	0.150***	3.62	0.153***	3.29
AUDFIRM	0.026**	2.57	0.028***	3.47	0.028***	2.78	0.028**	2.58
TENURE	-0.001	-0.19	-0.002	-0.26	-0.001	-0.19	-0.001	-0.16
CSOWN	0.082	1.11	0.088	1.22	0.080	1.13	0.084	1.31
CSTYPE	0.021**	2.13	0.022**	2.28	0.019**	2.25	0.014**	2.53
MOWN	0.067	1.14	0.070	1.20	0.067	1.15	0.052	0.92
RISK	-0.015*	-1.89	-0.014*	-1.82	-0.015**	-2.02	-0.016**	-2.25
DAC	0.175	0.89	0.153	0.82	0.185	0.96	0.204*	1.67
<i>Year</i>	Included		Included		Included		Included	
<i>Industry</i>	Included		Included		Included		Included	
<i>Country</i>	Included		Included		Included		Included	
Adjusted R ²	58.3%		59.1%		58.3%		58.9%	
Observation (n)	1,187		1,187		1,187		1,187	
Obs*R ² (White, 1980)	570.5***		559.7***		575.1***		587.7***	

where: RET_{it} is share return measured for twelve-months extending from nine months prior to the fiscal year through three months after the fiscal year-end calculated by natural logarithm share price of year t scaled to share price of year t-1; ΔEPS_{it} is firm's j earnings before extraordinary items per share in year t minus earnings before extraordinary items per share in year t-1, scaled by the beginning share price; EPS_{it} is earnings before extraordinary items per share, scaled by the beginning share price; *RPTYPE* represents one of the following vectors describing a magnitude RP transactions (RPT), RP complex, RP simple, and RP loan, scaled by the beginning total assets; $GROWTH_{it}$ is the previous year's growth,

calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $FSIZE_{it}$ is natural logarithm of total assets; $DEBT_{it}$ is a ratio of total debt to total assets; $BSIZE_{it}$ is a board size based on actual numbers of directors; $BDIND_{it}$ is a proportion of independent non-executive directors to total board members; $ACIND_{it}$ is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$ is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; $AUDFIRM_{it}$ is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$ is an actual tenure of auditor and client engagement; $CSOWN_{it}$ is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$ is an indicator variable equal to one if the controlling shareholder is individual or family group and zero otherwise; $MOWN_{it}$ is a percentage of managerial ownership; $RISK_{it}$ is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} is absolute discretionary accruals based on Modified Jones Model (1995); $Year$ is a vector of year indicator variables 2008, 2009 and 2010; $Industry$ is a vector of industry indicator variables based on the GICS industry classification; $Country$ is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand. $Year$, $industry$, and $country$ variables are not reported for brevity.

***, **, * indicate p-value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity.

The results imply that there is a differential impact between each type of RP transaction on informativeness of earnings from the market participants' perspective. It can be interpreted that investors and shareholders are more sensible about the potential of inefficient RP simple than RP complex. Investors may perceive that RP simple is likely to be used opportunistically to expropriate wealth or mislead shareholders about company earnings. They will discount the stock price of firms engaged in RP simple transactions, specifically RP loan. These findings, therefore, also suggest that investors may utilize the stock market to protect their interests from expropriation by opportunistic related parties.

7.5.2 Abnormal RP Transactions

I repeat the multivariate regression of Eq. 5.14 by including abnormal (magnitude changed) to replace magnitude RP transactions as the measurement. Similarly, the effect of abnormal RP transactions is represented as the coefficient α_4 in Eq. 5.14. The results are documented in Table 7.6B. Model 1 shows that the adjusted R^2 is 58.3%, where the model substantially assesses the importance of abnormal RP transactions in explaining the change in share returns.

Table 7.6B
The Effect of RP Transactions on Earnings Informativeness (RET)
(Abnormal RP Transactions)

	Model 1: RPT		Model 2: RP complex		Model 3: RP simple		Model 4: RP loan	
<i>Variable</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>coefficient</i>	<i>t-stat</i>	<i>Coefficient</i>	<i>t-stat</i>
Constant	-0.047	-0.13	-0.037	-0.10	-0.026*	-0.08	-0.052	-0.15
ΔEPS	0.086***	5.35	0.092***	4.91	0.087***	5.13	0.086***	5.51
EPS	0.253***	7.58	0.222***	5.41	0.236***	6.64	0.250***	7.06
ΔRPT	0.108	1.63						
$\Delta RPT * EARN$	-0.454***	-5.13						
$\Delta RP \text{ complex}$			0.242	1.29				
$\Delta RP \text{ complex} * EARN$			-1.197	-0.38				
$\Delta RP \text{ simple}$					-0.143	-1.40		
$\Delta RP \text{ simple} * EARN$					-0.432***	-3.51		
$\Delta RP \text{ loan}$							-0.31**	-2.09
$\Delta RP \text{ loan} * EARN$							-0.579***	-10.32
GROWTH	-0.020***	-2.88	-0.019***	-2.78	-0.065**	-2.03	-0.019***	-2.77
FSIZE	0.003	0.09	0.002	0.07	0.004	0.15	0.003	0.11
DEBT	-0.195***	-2.71	-0.199***	-2.86	-0.210***	-2.95	-0.193**	-2.55
BSIZE	0.009**	2.01	0.009**	2.04	0.009**	2.14	0.009**	1.96
BDIND	-0.015	-0.16	-0.030	-0.29	0.003	0.04	-0.018	-0.20
ACIND	0.027	0.35	0.027	0.42	0.019	0.29	0.025	0.39
AOPIN	0.148***	3.32	0.149***	3.52	0.151***	3.27	0.148***	3.45
AUDFIRM	0.025**	2.23	0.030***	3.11	0.031***	4.74	0.027***	3.27
TENURE	-0.002	-0.21	-0.002	-0.31	-0.002	-0.24	-0.001	-0.16
CSOWN	0.079	1.08	0.084	1.22	0.081	1.23	0.083	1.14
CSTYPE	0.019**	2.09	0.020**	2.40	0.015***	3.13	0.020***	2.72
MOWN	0.070	1.21	0.071	1.26	0.056	1.04	0.070	1.29
RISK	-0.015*	-1.91	-0.014*	-1.89	-0.016**	-2.24	-0.015**	-2.04
DAC	0.185	0.93	0.166	0.93	0.220	1.12	0.173	0.92
Year	Included		Included		Included		Included	
Industry	Included		Included		Included		Included	
Country	Included		Included		Included		Included	
Adjusted R ²	58.3%		58.2%		58.5%		58.7%	
Observations (n)	1,187		1,187		1,187		1,187	
Obs* R ² (White, 1980)	565.0***		566.6***		543.0***		574.8***	

where: RET_{it} is share return measured for twelve-months extending from nine months prior to the fiscal year through three months after the fiscal year-end calculated by natural logarithm share price of year t scaled to share price of year $t-1$; ΔEPS_{it} is firm's j earnings before extraordinary items per share in year t minus earnings before extraordinary items per share in year $t-1$, scaled by the beginning share price; EPS_{it} is earnings before extraordinary items per share, scaled by the beginning share price; $RPTYPE$ represents one of the following vectors describing an abnormal, ΔRPT , $\Delta RP \text{ complex}$, $\Delta RP \text{ simple}$ and $\Delta RP \text{ loan}$, scaled by the beginning total assets; $GROWTH_{it}$ is the previous year's growth, calculated based on market value of the firm at the end of year $t-1$ divided by the ending book value of the total assets at $t-1$; $FSIZE_{it}$ is natural

logarithm of total assets; $DEBT_{it}$, is a ratio of total debt to total assets; $BSIZE_{it}$, is a board size based on actual members of the board of directors; $BDIND_{it}$, is a proportion of independent non-executive directors to total board members; $ACIND_{it}$, is a proportion of independent non-executive members to total members of the audit committee; $AOPIN_{it}$, is an indicator variable equal to one if the auditor issued clean audit opinion, and zero otherwise; $AUDFIRM_{it}$, is an indicator variable equal to one if the firm is audited by Big 4, and zero otherwise; $TENURE_{it}$, is an actual tenure of auditor and client engagement; $CSOWN_{it}$, is a percentage of ownership belong to the controlling shareholder; $CSTYPE_{it}$, is an indicator variable equal to one if the controlling shareholder is individual or group of family and zero otherwise; $MOWN_{it}$, is a percentage of managerial ownership; $RISK_{it}$, is an operating risk measured based on natural logarithm of three years earnings standard deviation; DAC_{it} , is absolute discretionary accruals based on Modified Jones Model (1995); $Year$ is a vector of year indicator variables 2008, 2009 and 2010; $Industry$ is a vector of industry indicator variables based on the GICS industry classification; $Country$ is a vector of country indicator variables Hong Kong, Malaysia, Singapore, and Thailand. $Year$, $industry$, and $country$ variables are not reported for brevity.

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity.

I find that the coefficient of interaction $\Delta RP * EPS$ is negative (-0.454), are statistically related to RET and significant at level $p < 0.01$. This result shows that the abnormal RP transactions reduce the informativeness of earnings. This evidence suggests accepting the hypothesis H2 predicting the increase in magnitude of RP transactions will reduce firm valuation (earnings informativeness). The above negative association strengthens the magnitude RP transactions that have shown RP transactions reducing firm valuation.

Model 1 in Table 7.6B also shows that variables EPS (0.253) and ΔEPS (0.086) are associated significantly with RET at level $p < 0.01$, which is consistent with the prediction. The firm's attributes and governance control variables $BSIZE$ (0.009), $AUDFIRM$ (0.025), $AOPIN$ (0.148), and $CSTYPE$ (0.019) are positively associated with share returns, and significant at level $p < 0.01$ or $p < 0.05$. In contrast, control variables like $DEBT$ (-0.195) and $RISK$ (-0.015) have a negative relationship to share return, which is consistent with the prediction. The coefficient of $GROWTH$ is -0.020, significant at level $p < 0.01$, suggesting firm growth is associated with lower share return. Other control variables representing firms and corporate governance characteristics are insignificant. The associations between these

control variables and *RET* are consistent in Model 2, Model 3, and Model 4 as shown in Table 7.6B.

Model 2, Model 3, and Model 4 document the results of multivariate tests for the effect of abnormal types of RP transaction on share returns. The adjusted R^2 of these models is stable at 58.2%, 58.2%, and 58.7%, respectively. The results show that a relationship between abnormal of RP complex, RP simple, or RP loan and share returns is consistent with magnitude RP transactions. Model 2 shows the coefficient of interaction variable, $\Delta RP_{complex} * EPS$ is insignificant which means RP complex does not clearly affect informativeness of earnings. In contrast, Model 3 shows that the coefficient of interaction variable $\Delta RP_{simple} * EPS$ is negative (-0.432; $t=-3.51$) and associated with *RET*, and significant at level $p<0.01$. Additionally, Model 4 shows that the interaction variable, $\Delta RP_{loan} * EPS$, has a negative association with *RET*, where the coefficient is -0.579, and statistically significant at level $p<0.01$. These indicate that the abnormal RP simple, particularly RP loan, substantially reduces informativeness of earnings. Consistent with the magnitude, the empirical evidence indicates that RP simple, including RP loan has more impact on earnings informativeness than RP complex. Furthermore abnormal RP loan is negatively related to *RET* (the coefficient, -0.310, significant at level $p<0.05$). H2b and H2c can be accepted but H2a is rejected for predicting a negative association.

7.6 Discussion of Results

This section discusses the interpretations and findings from these three different firm valuation models. Based on Tobin's Q model, magnitude RP transactions provide evidence

that link RP transaction to poorer firm performance. This finding supports Dahya et al. (2008), Kohlbeck and Mayhew (2010), and Munir and Gul (2010) and Nekhili and Cherif (2011) who suggest the related-party's firms experience poorer market performance than a non-related party's firm. However, the results for abnormal RP transactions are not significant. The results for RP transactions' classifications according to the complexity consistently indicate that each type of RP transaction affects firm valuation differently. Both magnitude and abnormal measures have shown that RP simple is more severe than RP complex. The separation tests of RP loan from RP simple also provide consistent evidence that magnitude and abnormal RP loan substantially affect declining firm valuation. Overall, the evidence is consistent with Kohlbeck and Mayhew (2010) who conclude there is a differential impact between RP complex and RP simple, but the strongest negative impact on firm valuation is attributable to RP simple, particularly RP loan.

Based on earnings-market valuation models, the evidence empirically shows that both magnitude and abnormal RP transactions reduce market value of equity. Both magnitude and abnormal RP transactions also document a negative weighting on the interaction between RP transactions and earnings, suggesting the earnings value relevance is less for firms engaged in RP transactions. These results are consistent with Kohlbeck and Mayhew (2010) who document the market discounts firm engaged in RP transactions. Both measurements suggest that the differential impact on firm valuation exists between each type of RP transaction. In contrast to Tobin's Q, the results show that investors perceive both magnitude and abnormal RP complex as more severe than RP simple. However, the evidence from both magnitude and abnormal RP loan is that they reduce firm market

valuation and earnings value relevance. These outcomes can be interpreted as market participants being more concerned with RP loan being used opportunistically to expropriate wealth, rather than components of straight-forward transactions with related parties (RP simple). These findings contradict Kohlbeck and Mayhew (2010) who indicated that RP simple is harsher than RP complex. However, the results from RP loan are consistent with Kohlbeck and Mayhew (2010)⁵¹.

The results from the earnings informativeness model strengthen the above findings, particularly for Tobin's Q model. Both magnitude and abnormal RP transactions obtain similar results suggesting RP transactions reduce earnings informativeness. Consistent with Wang and Yuan (2012), the results suggest the market participants may perceive RP transactions increasingly being employed to opportunistically manage earnings or expropriate wealth. The results also can be interpreted in that investors differentiate between the potential impacts each type of RP transactions has. The models provide a consistent result for both measurements that suggest the negative effect of RP transactions on earnings informativeness is largely attributable to RP simple, specifically RP loan. Interestingly, investor and shareholder awareness about the opportunistic RP loan is higher than other components of RP simple. There is no evidence that RP complex is attributable to the association.

These findings imply the market participants may utilize the stock market as a protection mechanism that deters corrupt internal dealings. As a result, the firm valuation decreases as

⁵¹ Kohlbeck and Mayhew (2010) find RP complex is insignificant. RP simple is more severe than RP complex.

the investors may price earnings lower for firms indulging in RP transactions. This study finds the results are consistent and robust, which can be interpreted as managers or controlling shareholders employing RP transactions to compromise firm performance, and are associated with lower earnings value relevance and earnings informativeness. Finally, these results can be interpreted as market participants perceiving RP transactions as representing managers' or controlling shareholders' opportunistic behavior rather than efficient and legal transactions.

Apart from these findings, the study emphasizes that an investor's valuation is attributable to all types of RP transaction. Every type of RP transaction increases an investor's awareness of the executed transactions being abused. The evidence implies that investors and shareholders differentiate the likelihood of RP complex, RP simple, and RP loan being executed deceptively. Overall, investors perceive that straight-forward transactions with related parties, including directors (RP simple and RP loan) can be used opportunistically to expropriate wealth by tunneling cash or assets, and is expected to be more severe than a RP complex transaction. This study finds four out of six multivariate regressions confirm that RP simple has a larger impact on reducing firm valuation than RP complex.

The nature and complexity of the transaction may explain the relationships. RP complex is defined as those transactions often involving many reported financial accounts and involve many related parties (Kohlbeck & Mayhew, 2010). The nature is considered complex and thus expected to be difficult to detect any abusive transaction. However, it is noted consistently that the components of RP complex include RP sales of goods and services to

subsidiaries, associates, and joint-ventures, which are usually required to guarantee continuity of daily business operations. These kinds of RP transactions often involve recurring transactions, are designed to reduce a firm's risk, and must obtain approval from the shareholders regularly. The disclosure for this transaction is expected to be more transparent, thus market participants perceive RP complex may represent an efficient type of transaction. As a result, the investor may not largely discount this kind of internal contract or arrangement.

Another interesting point is the earning-market valuation models obtain results showing the investors positively weight the interactions between RP transactions and book value common equity. The results are similar for all types of RP transactions. This evidence is also consistent with Kohlbeck and Mayhew (2010) and Barth et al. (1998) concerning the valuation of firms. According to this argument, if the investors perceive that earnings are less important due to RP transactions increasing the risk of wealth expropriation, the investors may value book value of common equity higher than earnings. In this case concerning RP transactions, the valuation indicates that the balance sheet item, book value of equity (*BVE*) has a more important role in providing information about liquidation value. Overall, the market participants apparently view RP transactions negatively, thus they value RP transactions as reducing earnings value relevance. However, their impact is distinguished according to the complexity of a straight-forward transaction with related parties.

7.7 Additional Sensitivity Analysis

7.7.1 *RP Transactions Firms*

All the multivariate regressions are repeated using a set sample of firms that disclosed RP transactions only. The numbers of firms disclosing magnitude RP transactions are 285 firms for a total of 778 firm-year observations. There are 289 firms with a total of 807 firm-year observations for abnormal RP transactions. The objective is to find evidence for the effect of RP transactions on firms' market valuation by controlling firms without that transaction. This section discusses the results below as shown in Table 7.7A and Table 7.7B.

Tobin's Q result shows magnitude RP transactions have a negative association with Tobin's Q; the coefficient is -1.00 ($t=-3.65$) and significant at level $p<0.01$. However, the alternative measure, abnormal RP transactions, finds no association with Tobin's Q. These findings are consistent with the main findings (discussed in sections 7.3A & 7.3B). Further analysis on types of RP transactions finds magnitude RP complex (-1.09; $t=-3.03$), RP simple (-2.41; $t=-2.66$) and RP loan (-2.34; $t=-4.22$) have a negative relationship with Tobin's Q, and are significant at level $p<0.01$. Based on the abnormal there is no association between each type of RP transaction and Tobin's Q. Nevertheless, the coefficient of magnitude types of RP transaction suggests the differentiation impact of RP complex, RP simple, and RP loan on firm performance.

I also repeat the analyses using the earnings-market valuation model. The results are consistent with the main findings. It appears that all models document a negative and significant relationship between magnitude RP transactions and their group classifications

and market value of equity. Interactions of earnings and magnitude RP transactions and their group classifications also have a negative and significant association with the market value of equity. Interaction of book value of equity and magnitude RP transactions and their group classifications are significant and positively associated with the market value of equity. Analyses that employ abnormal RP transactions and their group classifications also find similar results, where RP transactions, RP complex, RP simple and RP loan have a negative relationship to *MVE*. These results suggest that both magnitude and abnormal RP transactions, and types of classification reduce the market value of equity and earnings value relevance. These results are considered robust in supporting the main findings as discussed in section 7.4.

Based on earnings informativeness model, I find the results for magnitude, and abnormal RP transactions are consistent with the main findings. The coefficient of an interaction between magnitude RP transactions and earnings are negative (-0.12 ; $t=-8.20$) and significant at level $p<0.01$. The interaction between abnormal RP transactions and earnings also has a negative association, where the coefficient is -0.36 ($t=-9.61$), and is statistically significant at level $p<0.01$. Both results suggest that investors perceive RP transactions are used to expropriate their wealth and therefore they discount firm value. The results also show that the negative associations are basically attributable to RP simple, particularly RP loan. The coefficients of interaction between earnings and RP simple or RP loan are negative and significant at level $p<0.01$. The magnitude and abnormal RP complex are insignificant and consistent with the main findings as discussed in section 7.5.

Table 7.7A: Partial Results The Effect of Magnitude RP Transactions on Firm Valuation (Related Party Firms only)

Tobin's Q Models					MVE Models				RET Models			
	RPT	RP complex	RP simple	RP loan	RPT	RP complex	RP Simple	RP loan	RPT	RP complex	RP simple	RP loan
Variable	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)
RPT	-1.00*** (-3.65)				-1.47*** (-3.79)				0.07 (0.95)			
RP complex		-1.09*** (-3.03)				-2.43*** (-5.89)				0.09 (0.90)		
RP simple			-2.41*** (-2.66)				-1.76*** (-5.48)				-0.13*** (-2.12)	
RP loan				-2.34*** (-4.22)				-0.51*** (-5.76)				-0.35*** (-2.08)
EPS*RPT									-0.12*** (-8.20)	0.13 (0.59)	-0.14*** (-6.07)	-0.33*** (-5.36)
BVE*RPT					1.76*** (4.07)							
EARN*RPT					-2.31*** (-2.80)							
BVE*RP complex						2.81*** (5.34)						
EARN*RP complex						-4.85*** (-4.30)						
BVE*RP simple							1.84*** (11.95)					
EARN*RP simple							-2.06* (-1.73)					
BVE*RP loan								0.59*** (13.33)				
EARN*RP loan								-0.18*** (-5.65)				
Adjusted R ²	34.6%	33.1%	27.1%	34.4%	72.5%	67.7%	70.8%	37.4%	60.1%	59.9%	60.1%	60.2%

Table 7.7B: Partial Results The Effect of Abnormal RP Transactions on Firm Valuation (Related Party Firms only)

Variable	Tobin's Q Models				MVE Models				RET Models			
	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan
	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)	β (t-stat)
ΔRPT	-0.39 (-0.30)				-2.68*** (-5.68)				0.08 (1.04)			
ΔRP complex		-4.83 (-0.64)				-1.39*** (-5.70)				0.26 (0.83)		
ΔRP simple			-0.21 (-1.31)				-0.47* (-1.73)				-0.17* (-1.93)	
ΔRP loan				-1.64 (-1.40)				-4.09** (-2.19)				-0.14** (-2.03)
$EPS * \Delta RPT$									-0.36*** (-9.61)	0.24 (0.43)	-0.36*** (-5.59)	-0.31*** (-6.37)
$BVE * \Delta RPT$					3.10*** (13.56)							
$EARN * \Delta RPT$					-3.82*** (-1.89)							
$BVE * \Delta RP$ complex						2.98*** (10.94)						
$EARN * \Delta RP$ complex						-9.91*** (-3.25)						
$BVE * \Delta RP$ simple							0.25* (1.84)					
$EARN * \Delta RP$ simple							-0.44 (-0.25)					
$BVE * \Delta RP$ loan								4.45** (2.42)				
$EARN * \Delta RP$ loan								-5.84*** (-3.63)				
Adjusted R ²	34.1%	27.8%	40.0%	32.9%	66.8%	67.6%	65.1%	66.5%	59.6%	59.5%	59.9%	59.8%

7.7.2 Alternative Measure of Abnormal RP Transactions

I also perform sensitivity analyses of abnormal RP transactions by using a different measure. Instead of the magnitude changed, I use the median value to determine the unexpected RP transactions for each firm to find evidence of the effect of RP transactions on firm's market. The results from the analyses are shown in Panel A, Panel B, and Panel C of Table 7.8. Tobin's Q result shows unexpected (abnormal) RP transactions have a negative association with Tobin's Q, which the coefficient is -0.494 ($t=-3.38$; $p<0.01$). This finding is contradicted with the main findings (discussed in section 7.3B). Further analyses on types of RP transactions find unexpected RP complex (-0.678; $t=-3.43$) and RP simple (-1.473; $t=-2.75$) have a negative relationship with Tobin's Q, and significant at level $p<0.01$. Panel A of Table 7.8 also shows that RP loan is negatively associated with Tobin's Q (-1.338; $t=-2.16$), significant at level $p<0.05$. The coefficient of RP complex, RP simple, and RP loan on Tobin's Q also suggests the differentiation impact of each type of RP transactions on Tobin's Q. The findings are consistent with magnitude RP transactions, the main findings discussed in section 7.3A. These findings may also indicate that the alternative measure may provide better determinant for abnormal RP transactions. The results of the effect of unexpected RP transactions on earnings market valuation are shown in Panel B of Table 7.8B. Table 7.8B, Panel B shows unexpected RP transactions have a negative association (-0.132; $t=-4.54$) with MVE, which significant at level $p<0.01$. The coefficient of $EARN*\Delta RPT$ is negative (-0.822; $t=-7.00$), which suggesting that the presence of unexpected RP transactions reduce earnings-market valuation. Consistent with the main finding, $BVE*\Delta RPT$ is positive (0.136; $t=5.46$) and significant at level $p<0.01$ that suggesting investors value higher book value of equity.

Table 7.8
Analyses on Abnormal RP Transactions (Measured Based on Median RP Transactions)

Panel A: Tobin's Q Model (n=1,191)

Model Variables	Δ RPT		Δ RP Complex		Δ RP Simple		Δ RP Loan	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
Δ RPT	-0.494	-3.38***						
Δ RP Complex			-0.678	-3.43***				
Δ RP Simple					-1.473	-2.75***		
Δ RP Loan							-1.338	-2.16**
Adjusted R ²	26.1%		26.3%		24.1%		26.0%	

Panel B: Earnings-Market Valuation Model (MVE) (n=1,191)

Model Variables	Δ RPT		Δ RP Complex		Δ RP Simple		Δ RP Loan	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
BE	0.626	5.61***	0.623	5.51***	0.642	6.34***	0.639	5.97***
EARN	4.127	6.47***	4.112	6.13***	4.521	9.06***	4.058	7.20***
Δ RPT	-0.132	-4.54***						
BVE* Δ RPT	0.136	5.46***						
EARN* Δ RPT	-0.822	-7.00***						
Δ RP Complex			-0.147	-2.14**				
BVE* Δ RP Complex			0.751	37.96***				
EARN* Δ RP Complex			-4.927	-2.93***				
Δ RP Simple					-0.939	-1.83*		
BVE* Δ RP Simple					0.708	4.27***		
EARN* Δ RP Simple					-3.646	-4.81***		
Δ RP Loan							-2.177	-3.07***
BVE* Δ RP Loan							0.475	2.67***
EARN* Δ RP Loan							-2.187	-5.15***
Adjusted R ²	69.0%		68.8%		68.4%		68.9%	

Panel C: Earnings Informativeness Model (n=1,187)

Model Variables	Δ RPT		Δ RP Complex		Δ RP Simple		Δ RP Loan	
	β	t-Stat.	β	t-Stat.	β	t-Stat.	β	t-Stat.
Δ EPS	0.086	4.99***	0.087	4.63***	0.083	4.75***	0.083	4.53***
EPS	0.241	6.34***	0.225	5.94***	0.249	7.36***	0.248	7.97***
Δ RPT	0.038	0.63						
EPS* Δ RPT	-0.162	-5.05***						
Δ RP Complex			0.057	0.93				
EPS* Δ RP Complex			-0.091	-1.36				
Δ RP Simple					-0.069	-0.87		
EPS* Δ RP Simple					-0.166	-4.61***		
Δ RP Loan							-0.274	-1.17
EPS* Δ RP Loan							-0.370	-4.52***
Adjusted R ²	58.4%		58.1%		58.3%		58.4%	

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

Further analyses on types of RP transactions also find that RP complex (-0.147; -2.14), RP simple (-0.939; $t=-1.83$), and RP loan (-2.177; $t=-3.07$) have a negative and significant relationship to MVE, at level $p<0.01$. The results for RP complex and RP loan are consistent with the main findings discussed in section 7.4.2. While the result of RP simple is contradicted, which the abnormal measure based on magnitude change is insignificant, which suggesting no impact on earnings-market valuation. This evidence is seemingly supports and suggests that the unexpected measure base on the median of RP transactions may provide better evidence about the relationship.

I also repeat the regressions to find the impact of unexpected RP transactions on informativeness of earnings. The results are shown in Table 7.8, Panel C. I find the result for RP transactions, and each type of RP transactions is consistent with the main findings (discussed in section 7.5.2). The coefficient of RP transactions is negative (-0.162; $t=5.05$), which substantially significant at level $p<0.01$. It suggests that the presence of unexpected RP transactions reduce informativeness of earnings. The coefficient of $EPS*\Delta RP\text{-}complex$ is insignificant, suggesting that investors do not diminish informativeness of earnings of firms engage in RP complex. In contradict, the coefficients of RP simple (-0.166; $t=-4.61$) and RP loan (-0.370; $t=-4.52$), which suggest that such transactions reduce informativeness of earnings. The evidence implies that the negative associations between unexpected RP transactions and informativeness of earnings are attributable to RP simple, particularly RP loan. Based on these results, I believe that the investors' perception is consistent with the

argument that RP transactions are used to expropriate wealth. Thus, they discount firm market performance and earnings value relevance of firms engage in any type of RP transactions. They also value lower earnings informativeness for firms engage in RP simple, mainly loan transaction with related parties.

7.7.3 Combined Test of RP Complex and RP Simple

I analyze further by regressing RP complex and RP simple simultaneously in one regression model. The objective of this analysis is to find evidence regarding the effect of RP transactions on firm valuation by considering a potential self-serving behavior may occur through using a combination testing of RP transactions. The results of the analyses are shown in Table 7.9, Panel A and Panel B. Based on magnitude RP transactions, I find that both RP complex (-0.68; $t=-5.10$) and RP simple (-1.78; $t=-2.27$) have a negative association with Tobin's Q, significant at level $p<0.01$ and $p<0.05$ respectively. These associations are consistent with the main findings (discussed in section 7.3A). Table 7.9A, Panel B also shows that only RP simple is associated with Tobin's Q, which slightly significant at level $p<0.10$ (the coefficient is -0.70; $t=-1.82$). In contrast, RP complex is insignificant.

I repeat the combining test for earnings-market valuation model and find both RP complex and RP simple have a negative association with MVE, the coefficients are -0.32 ($t=-2.11$) and -0.67 ($t=-2.24$) respectively. The results are consistent that suggesting RP complex and RP simple reduce the market value of equity. Both interaction variables, EARN*RP complex (the coefficient -0.22; $t=-11.85$) and EARN*RP simple (the coefficient -4.89; $t=-5.35$) also have a negative and significant relationship to MVE. These findings imply that

investors discount earnings-market valuation of firms engage in RP complex and RP simple. However, the result of RP simple is not aligned with the main finding (discussed in section 7.4B).

Table 7.9A

Combined Test the Effect of RP Complex and RP Simple on Firm Valuation

Panel A: Magnitude RP Transactions

Model Variable	Tobin's Q		MVE		Share Return	
	β	t-Stat.	β	t-Stat.	β	t-Stat.
BVE			0.60	5.10***		
EARN			4.68	8.68***		
RP Complex	-0.68	-5.10***	-0.32	-2.11**	0.08	0.90
BVE*RP Complex			0.04	6.53***		
EARN*RP Complex			-0.22	-11.85***		
RP Simple	-1.78	-2.27**	-0.67	-2.24**	-0.08	-0.73
BVE*RP Simple			0.83	5.10***		
EARN*RP Simple			-4.89	-5.35***		
Δ EPS					0.08	5.53***
EPS					0.25	6.15***
EPS*RP Complex					0.07	0.33
EPS*RP Simple					-0.15	-5.37***
Adjusted R ²	26.4%		69.3%		58.3%	
Observations	n=1191		n=1191		n=1187	

Panel B: Abnormal RP Transactions

Model Variable	Tobin's Q		MVE		Share Return	
	β	t-Stat.	β	t-Stat.	β	t-Stat.
BVE			0.78	6.85***		
EARN			3.67	6.02***		
Δ RP Complex	0.39	0.42	0.93	1.22	0.35	1.44
BVE* Δ RP Complex			0.10	2.65***		
EARN* Δ RP Complex			-13.76	-8.88***		
Δ RP Simple	-0.70	-1.82*	-1.15	-4.50***	-0.13	-1.26
BVE* Δ RP Simple			1.80	2.07**		
EARN* Δ RP Simple			-10.08	-2.46**		
Δ EPS					0.09	4.62***
EPS					0.24	7.30***
EPS* Δ RP Complex					-0.41	-2.38**
EPS* Δ RP Simple					-0.48	-4.37***
Adjusted R ²	26.6%		71.2%		58.7%	
Observations	n=1191		n=1191		n=1187	

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

Based on Tobin's Q and MVE model, the results may indicate that the self-serving behavior of RP complex and RP simple occur through the regression. However, the result for earnings informativeness model is consistent with the main findings (discussed in section 7.5B). I find that RP simple has a negative association with RET, the coefficient is -0.15 ($t=-5.37$), significant at level $p<0.01$. This evidence suggests that the investors discount firms engage in RP simple. However, the result shows RP complex is insignificant. Similar with earnings quality models, hypothesis H2c (RP loan) could not be tested simultaneously with H2b (RP simple) because a component of RP simple consists of RP loan. I believe that it would increase potential of a multicollinearity problem in the regression. Thus, consistent with the analyses 6.6.3, I execute further analyses to run H2a, H2b, and H2c simultaneously by separating RP simple into two categories, i.e., non-RP loan (H2b) and RP loan (H2c). The results are shown in Table 7.9B, Panel A and Panel B.

Table 7.9B shows that magnitude RP complex (-0.71; $t=-2.20$; $p<0.05$), RP simple (-5.44; $t=-2.60$; $p<0.01$), and RP loan (-0.18; $t=-1.99$; $p<0.05$) have a significant and negative association with Tobin's Q. These findings are consistent with the main findings (discussed in section 7.3B) that suggesting the negative impact of each type of RP transactions on firm's performance. However, Table 7.9A, Panel B also shows that only abnormal RP loan (-1.04; $t=-2.53$; $p<0.05$) has a significant relation to Tobin's Q, while, abnormal RP complex and non-RP loan (RP simple) are insignificant. This evidence may indicate that the negative association between abnormal RP simple and Tobin's Q (Table 7. 9A, Panel B) is attributable to RP loan.

Table 7.9B

**Combined Test the Effect of RP Complex, RP Simple without RP Loan (non-RP Loan)
and RP Loan on Firm Valuation**

Panel A: Magnitude RP Transactions

Model Variable	Tobin's Q		MVE		Share Return	
	β	t-Stat.	β	t-Stat.	β	t-Stat.
BVE			0.71	6.15***		
EARN			4.36	7.85***		
RP Complex	-0.71	-2.20**	0.21	1.30	0.10	1.15
BVE*RP Complex			0.02	2.58***		
EARN*RP Complex			-3.57	-5.68***		
RP Simple	-5.44	-2.60***	-1.98	-3.35***	-0.09	-0.49***
BVE*RP Simple			2.39	4.05***		
EARN*RP Simple			-3.49	-4.33***		
RP Loan	-0.18	-1.99**	2.05	1.61	-0.11	-2.65***
BVE*RP Loan			-0.17	-0.11		
EARN*RP Loan			-10.92	-2.26**		
Δ EPS					0.11	10.27***
EPS					0.25	5.80***
EPS*RP Complex					-0.09	-0.49
EPS*RP Simple					1.13	1.65
EPS*RP Loan					-1.82	-1.94**
Adjusted R ²	24.5%		70.9%		57.8%	
Observations	n=1191		n=1191		n=1187	

Panel B: Abnormal RP Transactions

Model Variable	Tobin's Q		MVE		Share Return	
	β	t-Stat.	β	t-Stat.	β	t-Stat.
BVE			0.07	2.80***		
EARN			6.85	30.28***		
Δ RP Complex	0.26	0.17	-0.10	-0.10	0.38	1.50
BVE* Δ RP Complex			0.88	2.22**		
EARN* Δ RP Complex			-10.99	-4.93***		
Δ RP Simple	-0.16	-0.41	1.07	1.54	0.10	0.99
BVE* Δ RP Simple			0.47	2.59***		
EARN* Δ RP Simple			-14.01	-6.72***		
Δ RP Loan	-1.04	-2.53**	-0.10	-0.07	-0.19	-2.87***
BVE* Δ RP Loan			1.76	2.43**		
EARN* Δ RP Loan			-2.73	-9.39***		
Δ EPS					0.10	9.86***
EPS					0.25	7.78***
EPS* Δ RP Complex					-0.31	-4.05***
EPS* Δ RP Simple					-0.50	-6.05***
EPS* Δ RP Loan					-0.06	-0.36
Adjusted R ²	26.2%		66.8%		58.5%	
Observations	n=1191		n=1191		n=1187	

***, **, * indicate p-Value significance at the 0.01, 0.05, and 0.10 level respectively using two-tailed significance tests. All results are based on White's (1980) after considering heteroskedasticity. All control variables are not reported for brevity.

Based on the earnings-market valuation model, I find only magnitude RP simple is significantly associated with MVE, while RP complex and RP loan are insignificant. However, the results of interaction variables, EARN*RP complex (the coefficient, -3.57; $t=-5.68$), EARN*RP simple (-3.49; $t=-4.33$), and EARN*RP loan (the coefficient, -10.92; $t=-2.26$) are associated significantly with MVE. The results are consistent with the argument that each type of RP transactions reduces earnings value relevance. RP complex and RP simple reduce the market value of equity. I also find consistent results for the similar tests by using abnormal measurement. These findings imply that investors discount earnings-market valuation of firms engage any types of RP transactions. The findings also indicate that investors perceive the potential of non-RP loan (RP simple) and RP loan are used opportunistically higher than RP complex.

Table 7.9B, Panel A also shows evidence that only EARN*RP loan (based on magnitude measurement) has a negative association with RET. The coefficient is -1.82 ($t=-1.94$), significant at level $p<0.05$. While, EARN*RP complex and EARN*RP simple are insignificant. This evidence suggests that the investors discount earnings informativeness of firms engage in RP loan more than non-RP loan (RP simple) and RP complex. However, I find a contradict result when the testing executed based on abnormal measure. Table 7.9B, Panel B shows that EARN*RP complex (the coefficient, -0.31; $t=-4.05$) and EARN*RP simple (the coefficient, -0.50; $t=-6.05$) have a negative relation to RET. These results suggest that the firms' engagement in RP complex and RP simple significantly reduce informativeness of

earnings. In contrast, abnormal RP loan is negatively associated with RET, which the coefficient is -0.19 ($t=-2.87$) and significant at $p<0.01$. However, the results of interaction variable, EARN*RP loan does not indicate that investors severely discount firms engage in RP loan. Based on these firm valuation models, the results may indicate that the self-serving behavior of RP complex and RP simple as well as RP loan occurs through the regression.

7.7.4 Economic Significance Test

I run additional economic significance analyses of the RP transactions, which consistent throughout the analysis in section 6.6.4. I illustrate the results of the analyses in Table 7.10. Based on Tobin's Q model, I find that F-value of model with magnitude RP transactions is 2.64, significant at $p<0.01$. This result shows that RP transactions have an economic significance in the regression model. It implies that the inclusion of the variable gives a better fit to the data. Thus, I can interpret that the negative relationship between RP transactions and firm value substantially caused by the presence of the variable. The result also shows that F-value of the regression model with abnormal RP transactions ($F=3.00$) is significant at $p<0.01$. This evidence substantially supports that the inclusion of abnormal RP transactions has an economic significance in determining its association with firm performance (Tobin's Q). Further tests on types of RP transactions show that the economic significances are remained for magnitude RP complex ($F\text{-value}=2.53$, $p<0.01$), magnitude RP simple ($F\text{-value}=1.57$, $p<0.05$) and abnormal RP complex ($F\text{-value}=3.00$, $p<0.01$). However, I find that abnormal RP simple and RP loan (both measure, magnitude and abnormal) are insignificant that suggesting a lack of economic significant.

Table 7.10
Economic Significance Test (F-Test)

	Tobin's Q			MVE			RET		
	R Square			R Square			R Square		
	Control Model	Testing Model	F	Control Model	Testing Model	F	Control Model	Testing Model	F
RPT	0.280687	0.282308	2.64***	0.669035	0.697879	37.01***	0.589836	0.592565	3.88***
RP Complex	0.276855	0.278421	2.53***	0.668916	0.671827	3.44***	0.589838	0.590898	1.50**
RP Simple	0.255226	0.256224	1.57**	0.668916	0.698484	38.02***	0.589836	0.5926	3.94***
RP Loan	0.27731	0.277603	0.47	0.668916	0.6191152	27.91***	0.594807	0.598467	5.29***
ΔRPT	0.241331	0.243277	3.00***	0.688302	0.710631	29.91***	0.589838	0.592268	3.46***
ΔRP Complex	0.241331	0.243277	3.00***	0.700326	0.719488	26.48***	0.589838	0.591122	1.82***
ΔRP Simple	0.276855	0.276971	0.19	0.656383	0.681138	30.10***	0.59331	0.596165	4.10***
ΔRP Loan	0.278816	0.279267	0.73	0.67013	0.696854	34.17***	0.589838	0.593826	5.69***
N	1,191			1,191			1,187		

Notes:

***, **, * Indicator that the variable significant at 1%, 5% and 10% respectively.

I repeated the analyses according to earnings market valuation (MVE) and earnings informativeness (RET) models. The results show that F-value of the regressions that include magnitude and abnormal RP transactions are significant in these two models. Based on the MVE model, the F-value of magnitude RP transactions are 37.01 ($p < 0.01$) and abnormal RP transactions are 29.91 ($p < 0.01$). As shown in Table 7.10, the F-value of magnitude and abnormal RP transactions in earnings informativeness models are 3.88 ($p < 0.01$) and 3.46 ($p < 0.01$) respectively. These findings indicate that the inclusion of RP transactions in these models has economic significances in determining its association with earnings market valuation and informativeness of earnings. The F-test's results in the inclusion of magnitude and abnormal each type of RP transactions (RP complex, RP simple and RP loan) in these two models (MVE and RET) are also significant. These variables, RP complex, RP simple and RP loan has substantial economic significance to the data in determining its association with value relevance and informativeness of earnings. In overall, the F-test's results imply that the additional of RP transactions and each type of the transaction could fit to the data in the regression models. Thus, it can be concluded the models are specified in determining the association between RP transactions (including RP complex, RP simple and RP loan) and firm value.

7.8 Summary and Conclusion

This chapter discusses the empirical results regarding the effect of RP transactions and type of classification on firm valuation. There are three different firm valuation models used to generate the empirical results: Tobin's Q, earnings-market valuation, and earnings informativeness. These models could ensure a robustness of the results. The test variable,

RP transactions and type of classification are measured using two different attributes, magnitude, and abnormal to consolidate the results. These three models show a robust negative relationship between RP transactions or interaction between earnings and RP transactions and Q , MVE and share return (RET). The result of Tobin's Q suggests that RP transactions are associated with lower firm performance. The earning-market valuation model also documents an association where RP transactions reduce the market value of equity and earnings value relevance. The earnings informativeness model provides evidence that strengthens the negative associations. The result suggests that earnings informativeness is less for firms disclosing RP transactions. The results for abnormal RP transactions also strengthen the negative relationship.

In addition, these three models are repeated using a sample by excluding firms that do not disclose RP transactions to check a robustness of the results. Both results for both magnitude and abnormal RP transactions confirm the negative association between RP transactions and firm valuation. Based on these results, this study concludes that the existence of RP transactions supports the conflict of interest view. The negative relationships explain the variations in returns, and market valuation implies the market participants' awareness of RP transaction being used opportunistically. Therefore, they perceive that a firm's involvement in internal dealing with related parties will affect their wealth, thus decrease companies' market valuation.

This chapter also supports the differential impact between RP complex and RP simple, as well as RP loan. These three firm valuation models have proven the relationship. Based on

the results of Tobin's Q models, both magnitude and abnormal measurements suggest that RP simple is more severe than RP complex. Results of the earnings-market valuation model show all types of RP transaction have a negative impact on firm market valuation, but RP complex has been seen more severe than RP simple. The impact of abnormal RP loan also is more harmful than other components of RP simple (non-RP loan). The results also show that the impact of RP complex and RP loan on earnings value relevance are more harmful than RP simple, which are proven by both magnitude and abnormal measurements. The earnings informativeness model reinforces the relationship in that RP simple and RP loan are more severe than RP complex in affecting lower earnings informativeness.

Although the evidence for types of RP transactions is mixed, I find four out of six models do support the contention that RP simple is more severe than RP complex. The results also show that market participants perceive RP loan as more severe than other types of RP transaction. The sensitivity tests also attest to the relationships being consistent. These findings suggest that different types of RP transaction affect firm valuation differently. Overall, this study concludes the negative effect is attributable to RP simple, particularly RP loan. This evidence is considered robust and supports Kohlbeck and Mayhew (2010) and Ryngaert and Thomas (2012) regarding the differential types of RP transactions.

Chapter 8

Summary and Conclusions

8.1 Summary of the Thesis

The main aim of this cross-country study is to investigate the effects of RP transactions and their type on earnings quality and firm valuation in East Asia. Prior literature posits that managers or controlling shareholders may utilize RP transactions opportunistically to fulfill their personal interests at the expense of other shareholders. It is emphasized that RP transactions are legal internal arrangements, and their existence could play a significant role in fulfilling the economic needs of a firm as a whole. It is not necessarily an indicator that the firm engages in greater earnings management or wealth expropriation. Certain RP transactions can be used to optimize the efficiency of daily business operations, help reduce transaction costs, and overcome any difficulties in production and liquidity. As internal dealings, the nature of RP transactions can be exploited by opportunist-related parties (managers or controlling shareholders) for their own benefit. In addition, managers or controlling shareholders may benefit by information asymmetry. If disclosure requirements are not sufficiently transparent, the related parties can conceal their personal interests behind the transaction that at the same time soundly fulfills businesses' economic needs. Therefore, it is relatively difficult to detect abusive RP transactions. Discussions on these theoretical arguments are found in Chapters 2 to 4.

Chapter 2 discusses the nature of RP transactions and institutional and regulation backgrounds behind the growing number of RP transactions among listed firms in East Asia. This chapter also discusses a theoretical framework that underlies RP transactions. Agency theory suggests that RP transactions raise agency conflicts Type I and Type II. These conflicts could result in RP transactions being embraced for two reasons. It could be an efficient transaction that is required to support a firm's daily business operations and improve its business performance. In contrast, it can be an opportunistic transaction to expropriate wealth from shareholders, mainly minority shareholders.

Chapter 2 also explores fundamental factors that encourage listed firms to engage in RP transactions. The Asian financial crisis of 1997-1998 sheds light on many factors encouraging firms to instigate internal transactions with related parties. The concentration of equity ownership by the controlling shareholders, particularly families, plays a major role in RP transactions and results in corrupt RP transactions. Furthermore, RP transactions are prevalent among group firms, where the internal market maximizes the welfare and economic benefits of all business groups. However, the internal market that is set up within the complex ownership and control structure of group-affiliated firms may lead to more abusive RP transactions. Finally, Chapter 2 reviews the potential of RP transactions as tools for tunneling or propping up activities.

Chapter 3 discusses the institutional setting and regulatory framework in East Asian countries facilitating RP transactions. Most East Asia countries lack shareholder protection and poor corporate governance practices in monitoring directors' behavior. The weaknesses

of corporate governance and shareholder protection was obvious during the Asian financial crisis in 1997, where most minority shareholders endured wealth expropriation by opportunistic controlling shareholders trying to bail-out distressed businesses. RP transactions are usually executed by senior management; therefore, without good corporate governance practices, no one can query the integrity of managers or controlling shareholders when they are self-dealing. In this kind of business landscape, investors' decision to invest in firms that engage in RP transactions will increase violations of business interest.

The chapter also explains that policy-makers and regulators in most countries in East Asia have reformed their corporate governance practices and amended the regulatory framework in order to rebuild investors' confidence. Chapter 3 also discusses the determinants of RP transactions found in prior literature that motivates firms to engage in transactions with related parties. These studies emphasize there is a lack of shareholder protection, weak corporate governance practices and regulatory framework. Certain economic determinants meet the characteristics of the business landscape in most of East Asia. The unique character of the East Asian business environment offers this study an ideal setting in which to examine the opportunistic behavior of managers or controlling shareholders in resorting to RP transactions.

Chapter 4 discusses how the hypotheses were developed. The discussion is organized in two phases. The first phase reviews prior studies in regard to the association between RP transactions and earnings quality as proxied by discretionary accruals. Since there no evidence confirming the efficiency of corporate governance reforms and amended regulatory

framework in East Asia, the predictions of the hypotheses are based on prior findings. The first hypothesis and sub-hypotheses predict that RP transactions are significantly and positively associated with discretionary accruals.

The second phase reviews prior studies on the effect of RP transactions on firm valuation from the perspective of market participants. This phase also sheds light on the consistency of prior findings supporting the argument that RP transactions do represent opportunistic transactions. The findings of some prior studies may be influenced by the revelation of large firms experiencing accounting scandals through RP transactions. Based on the literature, the second hypothesis and sub-hypotheses predict that RP transactions are significantly negative associated with firm valuation. Considering the corporate governance reforms and amended regulations on RP transactions in East Asia over the last decade, this study believes the current business environment will illustrate the precise effect of RP transactions, particularly from the perspective of investors. This study contributes to the RP transactions, earnings quality, and firm valuation literature by exploring research questions that can provide empirical evidence from emerging market economies with a broader international perspective, particularly with reference to business behavior in executing RP transactions.

Chapter 5 discusses the research design of this study. This study selects non-financial listed firms from Hong Kong, Malaysia, Singapore, and Thailand for 2008 to 2010. Essentially, they are selected because the ownership structure of most listed firms consists of controlling shareholders and groups of families. Additionally, these four economies are considered advanced in reforming and implementing corporate governance practices and regulatory

frameworks. They also fulfill technical requirements, particularly in providing information for executing the investigation. For example, the listed firms have to provide annual reports in English.

Chapter 5 also illustrates procedures used to test the predictions. This study analyses the procedures into two major sections: discretionary accruals (earnings quality) and firm valuation. The first uses two different models to estimate the discretionary accruals, the modified Jones model (Dechow et al., 1995), and performance-matched discretionary accrual model (Kothari et al., 2005). The latter model extends the modified Jones model by countering the risk of spurious estimation due to the firm experiencing previously suspicious financial performance. The effect of RP transactions and type of classification on discretionary accruals is examined using multivariate analysis. This examination provides evidence for managers or controlling shareholders utilizing RP transactions to manipulate earnings via accruals.

The second part investigates the effect of RP transactions and type of classification on firm valuation using three different valuation models. The first model is Tobin's Q which represents firm market performance, and it compares the market value of the firms to a replacement value of their assets. The second model is a market valuation model, based on the earnings value relevance model (Ohlson, 1995; Barth et al., 1998). This model differs from Tobin's Q as it focuses on the market value of the common equity, while Tobin's Q refers to market value of total assets (representing the firm value as a whole). The third model is earnings informativeness model which is based on a share return model developed

by Warfield et al. (1995). This examination provides evidence on investors' valuation of managers' or controlling shareholders' involvement in RP transactions.

This study measures RP transactions using two continuous measurements, based on magnitude, and abnormal (magnitude change) value of the transaction. Both magnitude and abnormal RP transactions and each type of classification are scaled by the beginning total assets. The measurement applies to all the testing models except for the earning-market valuation model, where both magnitude and abnormal RP transactions and each type of classification are scaled by the beginning book value of equity. The multivariate regressions for examining the hypotheses include control for other possible explanations due to the differences in firm and corporate governance attributes.

8.2 Summary of Findings

This section summarizes the primary findings from this study in two parts: The first part summarizes the effect of RP transactions on the discretionary accrual. The results show that:

- (a) Based on the modified Jones (*DAC*) model, magnitude RP transactions have a positive relationship to discretionary accrual. Managers or controlling shareholders may use RP transactions opportunistically to manage earnings via accruals. The alternative measures, abnormal RP transactions, also have a positive association with discretionary accrual. This strengthens magnitude RP transactions by showing that an increase in abnormal RP transactions raises the likelihood of RP transactions being used to manipulate earnings.

- (b) Based on the *PMDAC* model, this study found magnitude RP transactions have a positive association with discretionary accrual. After controlling the potential spurious estimation of discretionary accrual caused by experiencing unusual past financial performance, the multivariate regression provides evidence suggesting RP transactions may be used substantially in managing accruals. The alternative measure also shows a positive relationship between abnormal RP transactions and discretionary accrual. It supports the contention that RP transactions may be employed opportunistically by controlling shareholders to manage earnings. This *PMDAC* model ensures the robustness of the association between RP transactions and discretionary accrual. The magnitude and the change in magnitude of the transaction indicate the potential for earnings manipulation via accruals. It can be concluded that both models and measurements provide empirical evidence that firms' involvement in RP transactions reduces earnings quality.
- (c) The results also suggest that the managers or the controlling shareholders used each type of RP transaction differently. Both *DAC* and *PMDAC* models find the results are consistent. Based on the magnitude, the results show the associations between RP transactions, and discretionary accruals are attributable to RP simple transactions, specifically RP loan. Meanwhile, RP complex is insignificant. Based on the abnormal, the results also indicate that RP simple substantially contributes to the positive association between RP transactions and discretionary accruals. While RP complex remains insignificant, the evidence also demonstrates the changes in magnitude of RP loan have a significant relationship to discretionary accrual. Therefore managers or controlling shareholders differentiate the role each type of RP

transaction has. They favor utilizing RP simple rather than RP complex as tools to manage earnings. This study concludes the evidence is robust, suggesting that each type of RP transaction has a different impact on earnings quality.

The second part summarizes the effects of RP transactions on firm valuations as follows:

- (a) A multivariate regression on Tobin's Q finds an outcome showing magnitude RP transactions have a negative association with Q . This finding suggests the existence of RP transactions leading to poorer firm performance. However, the alternative measurement abnormal RP transactions are not significant and this suggests there is no association between abnormal RP transactions and Q .
- (b) A result from the earnings-market valuation model shows the magnitude of RP transactions are negatively related to market value of equity. An interaction of the magnitude RP transactions and earnings also has a negative association with the market value of equity. Based on the abnormal measurement, the result is consistent in showing a negative relationship between RP transactions and market valuation. The interaction of RP transactions and earnings also has a negative relationship with market value of equity. These findings are robust and suggest that RP transactions reduce the market value of equity and earnings value relevance. Both magnitude and abnormal also indicate the decrease in earnings value relevance, increase investors' reliance on the book value of equity to obtain information about a firm's liquidation.
- (c) The earnings informativeness model also shows the interaction of RP transactions, and earnings have a negative relationship to share return. The result for abnormal RP transactions as an alternative measurement is also consistent in that it strengthens the

negative relationship. Here managers' or controlling shareholders' involvement in RP transactions reduces informativeness of earnings.

In summary, these three models show empirically a robust negative relationship between RP transactions or interaction between RP transactions and earnings and Q, MVE and share return. The robust evidence strengthens the negative association between RP transactions and firm valuation, which supports the conflict of interest view. The negative relationships in explaining the variations of returns, and market valuation imply investors are aware that RP transactions may be used opportunistically. They may also perceive that a firm's involvement in internal dealing with related parties will harm their wealth. For this reason they seek to protect their wealth by reducing the valuation of the firm engaged in RP transactions.

This part reveals evidence supporting the view that differentials exist between RP complex, RP simple and RP loan. These three firm valuation models have proven the relationship, but the evidence is mixed.

- (a) Based on magnitude RP transactions, results of Tobin's Q suggest that RP simple is more severe than RP complex. The alternative measurement, abnormal RP transactions, also shows RP simple is more harmful than RP complex. Both magnitude and abnormal RP loan contribute to the negative relationship between RP simple on Tobin's Q.
- (b) Results of the earnings-market valuation model show that all types of RP transactions have a negative impact on firm market valuation. However, the results show that the

interaction between both magnitude and abnormal RP simple and earnings is not significant. These findings suggest that the investors perceive RP complex as being harsher than RP simple. However, separate tests of RP loan from RP simple suggest that RP loan is more severe than other components RP simple (non-loan RP simple).

- (c) The earnings informativeness models strengthen the relationship and posit that RP simple, particularly RP loan are more severe than RP complex. Both magnitude and abnormal of each type of RP transaction are consistent in suggesting this differentiation.

The sensitivity tests were executed by excluding non-related parties' firms, and the results show the relationships are consistent in all models and measurements. The results from the *DAC* and *PMDAC* models show that both magnitude and abnormal RP simple is more severe than RP complex. The finding for abnormal RP loan also suggests managers or controlling shareholders opportunistically manage accruals, while in contrast the magnitude RP loan is insignificant. The results from firm valuation models of each type of RP transactions are also consistent, on average, suggesting that the market participants perceive RP complex and RP loan as more severe than RP simple (non-RP loan). The results from the informativeness of earnings model also finds consistent results that RP simple, particularly RP loan, is more severe than RP complex. Market participants distinguish between the potential degrees of harm each type of RP transaction has on firm valuation. This study concludes that the investors or shareholders may fully utilize the stock price to protect their benefits by discounting the share price or market value of equity for firms involved in RP transactions. The following section discusses the implications arising from this study.

8.3 Implications of this Study

The findings have several implications for theory and practice. The evidence is consistent and considered robust. This study provides evidence for the usefulness of agency theory in understanding managers' or controlling shareholders' behavior in two types of agency conflicts, Type I, and Type II. From an internal perspective, the evidence shows their behavior in managing accrual through RP transactions, specifically the straight-forward RP simple and RP loan. RP transactions are used to realize managers or controlling shareholders' conflict of interest and to create ambiguous or misleading financial reports. The evidence from the external perspective shows that investors perceive RP transactions to undermine firms' wealth. The investors also perceive that the straight-forward transactions with related parties (RP simple and RP loan) are more likely to realize conflict of interest than RP complex.

These findings are consistent with prior studies and support the agency conflict whereby RP transactions represent opportunistic transactions (Gordon et al., 2007). The findings confirm that the market price protects against firms that engage in RP transactions, especially RP simple and RP loan. This study believes that the investors or shareholders can use the magnitude and abnormal of RP transactions disclosed in the annual reports to make a precise judgment about the transaction. This finding also strongly supports a separate consideration for different types of RP transactions. The findings in this cross-country Asian analysis can be generalized to a broader international perspective. Another major implication is that the findings may indicate the implementation of corporate governance reforms is insufficient for rebuilding investor confidence regarding RP transactions. Therefore, government and

regulators must find other strategic approaches that improve governance and shareholder protection.

The information provided in this thesis should encourage policy makers and regulators to strengthen existing guidelines and regulations. This study provides evidence that there is one loophole to be investigated and overcome. Empirical evidence from the internal perspective emphasizes that managers or controlling shareholders substantially used RP simple to manage accruals, maybe for concealing their tunneling activities. The evidence from the external perspective shows the investors' are concerned that RP simple is more risky and will be used to expropriate firm wealth. Although evidence from investors is slightly mixed, they consistently indicate their perceptions that RP simple is more severe than RP complex. Thus, a specific strategy, guideline or regulation should be implemented with caution to minimize the risk of RP simple in order to rebuild investors' confidence in the capital market. This study draws attention to the regulators, standard setters, and policy makers that each type of RP transactions should be considered separately.

Furthermore, I also emphasize about the decision that has been taken by Malaysian regulators by banning RP loan is more likely aligned with the investors' concern. The results of all models and measurements have proven that investors discount value of firms engaged in RP loan. These findings are robust that indicate the investors continuously disbelief that RP loan is executed honestly at an arm-length-transaction. Thus, I believe that these findings strongly recommend that the regulators and policy makers in other East Asia countries should reconsider, amend and implement the similar provision. Boards of

directors of publicly listed firms should also carefully consider the potential market costs and different impacts of RP transactions classifications when deciding whether or not to approve RP transactions.

8.4 Limitations of the study

This study was conducted in peculiar specific context. It is, therefore, essential that the scope and the limitations of the study are outlined to minimize the external validity issues. The findings from this study are robust but it must be considered within the context of the limitations of the study. The empirical tests focus on Hong Kong, Malaysia, Singapore, and Thailand, however, the results may not be generalizable to other countries, specifically since China and Western economies have different business environments. The sample of this study may impose some limitation on the findings. This study calculates the magnitude and abnormal RP transactions based on the information disclosed in businesses' annual reports. It is possible that the firms engaged in RP transactions do not disclose these transactions. It is also possible that the firms may disclose a non-existent RP transaction. Thus, these results are best interpreted as documenting a negative firm valuation (performance, earnings valuation relevance, earnings informativeness), and a reduced earnings quality might be subjected to disclosed information.

This study converts all the local currency of the listed firms into USD\$ using the closing exchange rates provided on the OSIRIS database. The exchange rate is consistent with the financial data retrieved from the database, which have been converted into USD\$. This study contends that the given rate is the best solution to avoid exchange rate fluctuation

during the closing of account's date. Thus, the findings may ignore the potential difference in exchange rates due to price fluctuations during the closing of account's date. Furthermore, the data for RP loan includes advances to or from related parties. The amendment of the Malaysian Companies Act 1965 in 2007 included a ban on loans to or from related parties. Therefore, there are no Malaysian listed firms that disclose loans to related parties during 2007-2010. Consequently, this study finds Malaysian firms behaved peculiarly in their disclosure of advance payments to or from related parties, instead of RP loan. Based on the nature of these advances, this study classifies the advances as a part of RP loan.

This study also finds that the corporate governance reform in East Asia is being implemented in different stages. The actual period following the implementation of the reforms to date may differ. This study does not attempt to compare the impact of reform implementation, thus this study does not include additional controls to generate the results. In addition, it is difficult to measure both fair value of the assets or their replacement cost. Therefore, this study measures Q as the ratio of the sum of the market value of common equity and book value of total assets minus book value of equity to book value of total assets. This approach is consistent with the original model devised by Tobin (1969), Tobin and Brainard (1977), and Dahya et al. (2008).

Finally, it is assumed that boards of directors, auditors, shareholders and investors are unable to unravel all the information contained in annual reports, which makes opportunistic accruals management through RP transactions possible. It has been acknowledged that even

auditors who have access to source documents cannot hinder accruals-earnings management completely because managers use allowable techniques to influence earnings. Furthermore the structure of corporate governance alone without considering human relationships may not overcome the threat of management opportunism. Managers or controlling shareholders have considerable power with respect to executing RP transactions, including what types of contracts the firm enters into and the monitoring mechanisms, which are in place. Thus, the market responds to potential harm through market price protection, where they discount performance, valuation and earnings informativeness of firms engaged in RP transactions.

8.5 Suggestions for Future Research

Extending the current study should occur in the following areas:

1. It would be useful to examine the role of tenure auditor-client relationship in monitoring RP transactions. Gordon et al. (2007) emphasize that those firms are likely to appoint auditors with whom do they have a relationship in order to manipulate financial reporting via RP transactions. I believe that a close relationship can be developed through longer auditor engagement. The auditor may become complacent and not rigorous enough in questioning clients (management or controlling shareholders) regarding RP transactions. Instead of better expertise and audit quality, a longer tenure auditor-client relationship could trap the auditors into entering a conflict of interest. There is no empirical evidence to date confirming the relationship as stated by Gordon et al. (2007). I include the tenure auditor client-relationship as a control variable due to time limitation. The data shows that on average, the selected listed firms in this sample had a relationship with the same

auditor for more than six years. Investigating the effect of longer tenure auditor-client relationship in monitoring RP transactions will provide important insights into this issue.

2. In earnings quality studies, there is no single best proxy being used to measure earnings quality. It would be valuable to investigate the effect of RP transactions on earnings quality from different perspectives. Future studies can build on this study by examining the effect of RP transactions on an accounting conservatism and an accuracy of earnings forecast. Sherman and Young (2001) emphasized that the existence of RP transactions might indicate aggressive accounting. The prediction is that the firms engage in RP transactions would practice less accounting conservatism, but it is not empirically proven. If RP transactions reduce earnings quality, the prediction is a lack of accuracy in earnings forecast.
3. The corporate governance reforms and regulatory amendments that have taken place in East Asia is occurring only gradually since the 1997-1998 financial crisis. Hong Kong had the first corporate governance code, the 1993 Voluntary Code of Best Practice. Malaysia introduced its best practice of corporate governance in 2000. Singapore issued codes in 2001 and Thailand in 2002. Over the last decade, these reforms have been countering RP transactions continuously in different ways throughout East Asia. It is valuable if future studies could include when amendments and reforms are actually implemented, to create a comparison for analysis.

4. Investors may believe that RP transactions are becoming more corrupt, which is due to less effective corporate governance. Thus, the investors may be not reluctant to invest in related parties' firms if they believe that the corporate governance control mechanisms are effective. This study suggests that future research should include the role of effective corporate governance in mediating the negative impact of RP transactions.

8.6 Conclusions

This study provides evidence on the effect of RP transactions from two different perspectives. First, this study explores the possibility of firms' managers or controlling shareholders opportunistically using RP transactions as tools to manage earnings via accruals. Second, this study explores the investors' perceptions of RP transactions. Overall, the results indicate that RP transactions are used opportunistically by managers or controlling shareholders to manipulate earnings. The results also suggest that the investors perceive RP transactions as being used to expropriate wealth (cash or assets). This study documents that the market participants, investors and shareholders discount the value of firms that are engaged in RP transactions. It is shown in the form of poorer performance (*Q*), valuations, and earnings informativeness. Both measurements are consistent in that magnitude and abnormal RP transactions derive similar results.

From the internal perspective, the results suggest consistently that RP simple is substantially used in accruals-earnings management compared to RP complex. This evidence shows that the manager or controlling shareholders treat each type of RP transaction differently. The

results from the market valuation perspective are mixed. However, overall the market participants perceive that the impact of RP simple, particularly RP loan, is more severe than RP complex. Four out of six firm valuation models suggest RP simple is harsher than RP complex. Thus, the market participants generally do not appear to value RP complex. The above findings have proven that a differential exists among types of RP transaction, and should be countered differently.

In general, findings of this study are consistent with the agency conflict perspective. Once a manager or controlling shareholder does not fully own the firm, he/she has strong incentives to consume business resources so that he or she does not bear the full cost of such consumption. The findings from both the internal and market-based perspectives suggest that RP transactions may be used opportunistically to maximize personal benefit, which is consistent with the conflict of interest view (Gordon et al., 2007). Thus, this study contributes to the existing literature by: 1) documenting the relationship of RP transactions and earnings quality in context of discretionary accruals, 2) presenting the market valuation of earnings, which are affected by the existence of RP transactions, and 3) exposing the differentials within certain types of RP transactions.

Appendix I

Types of Related Party Transactions

Description

RP complex transactions include the following:

- Related business activities that are related to the firm's main operations.
- Unrelated business activities that are incidental to the firm's main operations.
- Stock transactions that involving transfers of assets and business.

RP simple transactions include the following:

- Consulting arrangement by providing services to or receiving services from related parties
- Legal or investment services that is obtained from the related party
- Lease or rental agreement to lease space of properties to or from related parties
- Administration services to related parties for a fee
- Loans to related parties, and borrowing from related parties
- Guaranteed debt belong to related party or the firm's debt is guaranteed by related parties
- Any transaction with related parties that is not categorized as above.

RP loan transaction is also included as RP simple transaction. Instead of RP simple as a whole, RP loan is examined separately to look for the effect individually.

Appendix II

An Example of RP Transactions Classifications (Thai's Firm)

This information is extracted from the annual report of CH Karnchang Public Company Limited for financial year 2010.

RP complex						(Unit: Million Baht)
Transactions	Group		Company		Transfer Pricing Policy	
	2010	2009	2010	2009		
Transactions with subsidiaries (eliminated from the consolidate financial statements):						
Project management income	-	-	2.9	-	Based on contract	
Rental & transportation income	-	-	77.1	301.4	Close to service fee charged to third parties	
Space rental & service income	-	-	5.9	6.0	Based on contract	
Interest Income	-	-	97.4	24.3	Interest rates of MLR + 0.25% (2009: 6.25% to 8.25%, MLR + 0.25% & MLR + 0.5%)	
Dividend income	-	-	8.3	16.5	As declared	
Other income	-	-	34.9	14.3	Cost plus margin & agreed between the parties	
Cost of construction materials & construction work	-	-	23.6	51.5	Close to prices charges by third parties	
Administrative expenses	-	-	0.5	0.5	Agreed between the parties	
Transactions with related parties:						
Revenues from construction services	944.1	316.8	113.6	184.3	Based on construction contracts	
Sales of construction materials	-	2.2	-	-	Cost plus margin	
Project management income	3.8	1.8	-	-	Based on contracts	
Rental & transportation income	1.0	4.5	0.4	1.7	Close to service fee charged to third parties	
Space rental & service income	13.9	13.5	13.9	13.5	Based on contracts	
Interest income	7.9	52.1	7.9	18.0	Interest rate of MLR + 1%	
Dividend income	157.8	145.9	145.8	135.0	As declared	
Other income	6.6	0.4	0.4	0.3	Based on contracts & close to service fee charged to third parties	
Cost of construction materials & construction work	18.9	220.6	0.8	0.7	Close to prices charged by third parties	
Administrative expenses	2.5	1.6	0.2	-	Agreed between the parties	
Interest expenses	0.1	-	-	-	Interest rate of MLR & MLR + 0.25%	

RP simple

Appendix III

An Example of RP Transactions Classifications (Thai's Firm including RP Loan)

This partial information is extracted from the annual report of Big C Supercenter Public Company Limited for financial year 2010.

Transactions	RP complex		(Unit: Thousand Baht)	
	Group		Company	
	2010	2009	2010	2009
Transactions with subsidiaries:				
Sales of Goods	-	-	1,965,866	1,815,716
Rental & Service income	-	-	35,956	44,084
Interest Income	-	-	160	1,060
Dividend income	-	-	421,931	417,719
Purchase of goods	-	-	62,780	27,128
Rental & Service expenses	-	-	477,769	444,172
Interest expenses	-	-	32,070	41,437
Transactions with related companies:				
Other income	83,799	78,015	82,904	77,149
Rental & Service income	263,127	243,653	239,989	220,364
Purchases of goods	23,582	28,355	21,870	26,373
Rental & Service expenses	226,769	220,185	202,083	196,065
Management fees expense & other expense	120,251	58,185	119,770	58,419
Tax consulting fee	1,200	1,200	1,200	1,200

During 2010, movement of loans to and loans from subsidiaries companies were as follow:

Transactions	Balance as at	During the year		Balance as at
	1 Jan. 2010	Increase	Decrease	31 Dec. 2010
Loans to subsidiaries:				
Central Superstore Co., Ltd.	13	50,239	50,252	-
Udon Big C Co., Ltd	2	18,947	18,949	-
Pitsanulok Big C Co., Ltd	444	1,577,127	1,577,496	75
Big C Fairy Co., Ltd	222	1,952,987	1,953,099	110
Theparak Big C Co., Ltd.	8	23,933	23,941	-
Chiengrai Big C Co., Ltd	1,957	13,839	13,839	1,957
Inthanon Land Co., Ltd	-	13,055	13,055	-
Flexpay Co., Ltd	47,232	3,241	50,473	-
Central Pattaya Co., Ltd	75	16,176	16,251	-
Total Loans to subsidiaries	49,954	3,683,491	3,731,303	2,142
Loans from subsidiaries:				
Central Superstore Co., Ltd.	249,327	307,250	175,958	380,619
Pitsanulok Big C Co., Ltd	55	238	293	-
Big C Fairy Co., Ltd	78	1,145	1,223	-
Surat Big C Co., Ltd	113,272	31,055	18,277	126,050
Theparak Big C Co., Ltd.	1,379,272	2,165,034	2,052,094	1,492,212
Chiengrai Big C Co., Ltd	115,505	79,117	52,518	138,104
Big C Distribution Co., Ltd	3,488	45	177	3,356
Chiengmai Big C (2001) Co., Ltd	311,800	5,636	7,608	309,828
Total Loans from subsidiaries	2,168,797	2,589,520	2,308,148	2,450,169

Appendix IV

An Example of RP Transactions Classifications (Malaysian Firm)

This partial information is extracted from the annual report of Kuala Lumpur Kepong Berhad for financial year 2010.

36. RELATED PARTY TRANSACTIONS

(a) The company has a controlling related party relationship with all its subsidiaries. Significant inter-company transactions of the Company are as follows:

Transactions	Company	
	2010 (RM'000)	2009 (RM'000)
Purchases from subsidiaries	26,580	56,025
Sales to subsidiaries	104,242	137,016
Commission received from a subsidiary	1,758	1,672
Interest received from a subsidiaries	23,728	18,355
Rental received from a subsidiary	450	-
Management fees paid to subsidiaries	4,297	4,425
Rental paid to subsidiaries	195	780
License fees paid to subsidiaries	11,861	14,283

RP complex

RP simple

b) Significant related party transactions

Set out below are the significant related party transactions in the normal course of business for the financial year (in addition to related party disclosures mentioned elsewhere in the financial statements). The related party transactions described below carried out on terms and conditions not more materially different from those obtainable in transactions with unrelated parties.

Transactions	Group		Company	
	2010 RM'000	2009 RM'000	2010 RM'000	2009 RM'000
Transactions with associates:				
Sales of Goods	5,901	6,631	1,274	1,397
Purchase of goods	6,665	6,277	6,118	4,071
Service charges paid	1,969	1,853	619	591
Research and development services paid	5,698	5,435	5,698	5,435
Transactions with companies in which certain Directors are common directors and/or have direct or deemed interest:				
Purchase of goods				
Bukit Katho Estate Sdn Bhd	6,821	4,974	6,821	4,974
Kampar Rubber & Tin Co Sdn Bhd	12,713	10,459	12,713	10,163
Malay Rubber Plantations (M) Sdn Bhd	11,392	9,673	11,392	9,503
P.T. Agro Makmur Abadi	24,103	13,061	-	-
P.T. Safari Riau	13,489	10,189	-	-
Taiko Fertiliser marketing Sdn Bhd	34,713	-	12,580	-
Taiko Marketing Sdn Bhd	13,843	44,714	260	7,632

Appendix V

Variance Inflation Factor (VIF) for Discretionary Accruals Models

Variables	VIF: DAC Models								VIF: PMDAC Models							
	Magnitude				Abnormal				Magnitude				Abnormal			
	RPT	RP complex	RP simple	RP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan	RPT	RP complex	RP simple	RP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan
RPT	1.26								1.27							
RP complex		1.17								1.18						
RP simple			1.17								1.19					
RP loan				1.16								1.16				
ΔRPT					1.03								1.03			
ΔRP complex						1.03								1.03		
ΔRP simple							1.04								1.03	
ΔRP loan								1.06								1.07
GROWTH	1.11	1.11	1.12	1.11	1.04	1.11	1.11	1.06	1.11	1.11	1.12	1.11	1.11	1.11	1.11	1.05
FSIZE	2.17	2.16	2.17	2.16	2.16	2.17	2.17	2.16	2.17	2.17	2.17	2.17	2.17	2.17	2.17	2.17
DEBT	1.23	1.22	1.23	1.22	1.21	1.23	1.23	1.22	1.23	1.23	1.23	1.23	1.23	1.23	1.23	1.22
BSIZE	2.14	2.15	2.14	2.14	2.10	2.14	2.14	2.13	2.14	2.14	2.14	2.14	2.14	2.14	2.14	2.10
BDIND	1.59	1.59	1.58	1.58	1.56	1.58	1.58	1.58	1.59	1.59	1.58	1.58	1.58	1.58	1.58	1.60
ACIND	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42	1.42
AOPIN	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04	1.04
AFIRM	1.34	1.34	1.34	1.34	1.34	1.35	1.34	1.34	1.34	1.34	1.34	1.34	1.34	1.35	1.34	1.34
TENURE	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22	1.22
CSOWN	1.11	1.11	1.12	1.12	1.12	1.11	1.11	1.11	1.11	1.11	1.11	1.11	1.11	1.11	1.11	1.12
CSTYPE	1.24	1.25	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24
MOWN	1.30	1.29	1.30	1.29	1.29	1.30	1.30	1.29	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
RISK	1.03	1.03	1.03	1.03	1.02	1.03	1.03	1.02	1.03	1.03	1.03	1.03	1.03	1.03	1.03	1.02

Appendix VI

Variance Inflation Factor (VIF) for Firm Valuation Models : Magnitude

Variables	Tobin's Q Model				Earnings-Market Valuation Model				Earnings Informativeness Model			
	RPT	RP complex	RP simple	RP loan	RPT	RP complex	RP simple	RP loan	RPT	RP complex	RP simple	RP loan
BVE					3.12	3.11	3.11	3.11				
EARN					2.84	2.83	2.89	2.85				
ΔEPS									1.36	1.37	1.35	1.35
EPS									1.37	1.38	1.37	1.38
RPT	3.54				1.27				1.34			
RP complex		3.24				1.18				1.25		
RP simple			2.96				1.22				1.18	
RP loan				3.01				1.15				1.26
GROWTH	1.45	1.48	1.72	2.07	1.06	1.06	1.06	1.06	1.09	1.09	1.10	1.11
FSIZE	7.52	7.98	8.53	8.06	2.55	2.53	2.53	2.53	3.47	3.47	3.48	3.47
DEBT	4.04	4.47	5.03	4.56	1.29	1.29	1.29	1.29	1.27	1.27	1.28	1.29
BSIZE	3.47	3.54	3.76	3.92	2.31	2.31	2.31	2.30	2.36	2.36	2.33	2.33
BDIND	2.67	2.77	3.06	2.73	1.62	1.62	1.62	1.62	1.73	1.73	1.73	1.73
ACIND	2.25	2.37	2.96	2.48	1.43	1.43	1.43	1.43	1.58	1.58	1.58	1.58
AOPIN	1.32	1.29	1.44	1.30	1.04	1.04	1.04	1.04	1.11	1.11	1.11	1.11
AFIRM	2.44	2.58	2.69	2.64	1.34	1.34	1.35	1.34	1.50	1.51	1.52	1.52
TENURE	2.15	2.38	2.56	2.30	1.23	1.23	1.23	1.23	1.32	1.32	1.33	1.32
CSOWN	2.63	2.85	3.85	2.87	1.12	1.12	1.13	1.13	1.20	1.20	1.20	1.19
CSTYPE	3.15	3.12	3.26	3.04	1.26	1.26	1.26	1.26	1.41	1.41	1.42	1.42
MOWN	2.87	3.15	3.99	3.09	1.32	1.32	1.31	1.32	1.33	1.33	1.34	1.34
RISK	2.05	2.21	2.55	2.17	1.04	1.04	1.03	1.03	1.10	1.10	1.09	1.10
DAC	1.34	1.36	1.58	1.34	1.09	1.09	1.09	1.09	1.13	1.13	1.13	1.13

Appendix VII

Variance Inflation Factor (VIF) for Firm Valuation Models: Abnormal

Variables	Tobin's Q				Earnings-Market Valuation Model				Earnings Informativeness Model			
	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan	ΔRPT	ΔRP complex	ΔRP simple	ΔRP loan
BVE					3.18	3.18	3.14	3.17	1.36	1.36	1.36	1.36
EARN					2.89	2.90	2.85	2.84	1.37	1.37	1.37	1.38
ΔEPS												
EPS												
ΔRPT	1.53				1.06				1.08			
ΔRP complex		2.95				1.02				1.10		
ΔRP simple			1.38				1.05				1.06	
ΔRP loan				2.58				1.06				1.09
GROWTH	2.42	5.23	1.69	1.52	1.11	1.11	1.06	1.06	1.09	1.11	1.20	1.12
FSIZE	7.45	6.36	8.80	7.87	2.55	2.55	2.54	2.54	3.47	3.48	3.39	3.47
DEBT	4.92	5.01	4.62	4.35	1.29	1.29	1.29	1.29	1.27	1.27	1.27	1.27
BSIZE	3.64	3.74	3.65	3.69	2.30	2.30	2.28	2.28	2.33	2.33	2.35	2.33
BDIND	2.87	3.42	2.73	2.75	1.62	1.62	1.60	1.60	1.72	1.72	1.73	1.72
ACIND	2.91	2.52	2.30	2.42	1.43	1.43	1.43	1.43	1.58	1.58	1.58	1.58
AOPIN	1.31	1.33	1.32	1.28	1.04	1.04	1.04	1.04	1.11	1.11	1.11	1.11
AFIRM	2.37	2.51	2.57	2.75	1.34	1.34	1.34	1.34	1.50	1.51	1.50	1.51
TENURE	2.55	3.16	2.21	2.35	1.63	1.23	1.23	1.23	1.33	1.34	1.32	1.32
CSOWN	3.05	4.50	2.73	2.74	1.12	1.13	1.13	1.12	1.20	1.20	1.20	1.20
CSTYPE	2.97	3.36	2.81	3.08	1.26	1.26	1.26	1.26	1.41	1.41	1.42	1.41
MOWN	3.64	3.09	2.64	3.23	1.31	1.31	1.31	1.31	1.33	1.34	1.33	1.34
RISK	2.50	3.42	2.17	2.17	1.03	1.03	1.03	1.03	1.09	1.10	1.09	1.10
DAC	1.63	1.93	1.29	1.53	1.09	1.09	1.09	1.09	1.13	1.12	1.14	1.13

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