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An empirical study of voluntary transfer pricing disclosures in China

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A B S T R A C T

This paper empirically investigates the factors that affect the management's voluntary disclosures of the transfer pricing details of related-party transactions. Using Chinese data from 2004 and 2005, we hypothesize and find that firms that make voluntary disclosures of the pricing methods of related-party transactions are negatively associated with (i) a higher level of earnings management (as captured by abnormal related-party transactions) and (ii) its underlying incentives (as captured by the management's performance-linked bonuses and the firm's incentives to achieve earnings targets); further, they are positively associated with (i) a higher percentage of independent directors and (ii) a higher percentage of government ownership. Overall, our findings suggest that earnings management and its incentives, board composition, and ownership structure significantly influence the voluntary disclosure decisions of managers.

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1. Introduction

Previous studies suggest that managers voluntarily disclose information to reduce information asymmetry and to minimize investor-driven adverse selection effects (Wagenhofer, 1990; Lundholm and Van Winkle, 2006). Healy et al. (1999) find that an increase in disclosure ratings is associated with an increase in firms' stock returns, institutional ownership, analyst forecasts, and stock liquidity. Cheung et al. (2010) reveal a positive relation between firms' voluntary disclosures and their market valuation. Other studies show that greater levels of disclosure are associated with a

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lower cost of equity and debt capital (Botosan, 1997; Sengupta, 1998; Richardson and Welker, 2001; Francis et al., 2005). Despite these many benefits, in practice, managers may elect to not voluntarily disclose information because of the costs of disclosure (Verrecchia, 1983; Graham et al., 2005; Suijs, 2005).[1] Therefore, the identification of factors that affect the voluntary disclosure decision is an important research topic that has implications for policy-makers, auditors, investors, and other stakeholders.

Voluntary disclosures examined by other studies include management earnings forecasts (Nagar et al., 2003; Ajinkya et al., 2005; Karamanou and Vafeas, 2005), personnel announcements (Miller, 2002), and environmental disclosures (De Villiers and Van Staden, 2006; Clarkson et al., 2008), among others. One neglected area of research concerns the disclosure of related-party transactions. Previous studies provide empirical evidence that related-party transactions are widely used to shift income and manage earnings for financial reporting and tax purposes (Harris, 1993; Jacob, 1996; Wang et al., 2008; Aharony et al., 2010; Jian and Wong, 2010; Lo et al., 2010a,b). However, to the best of our knowledge, no preceding study has empirically examined the economic determinants of related-party transaction disclosures. We contribute to the current literature by examining the voluntary disclosure of transfer pricing methods used for related-party transactions in China.

The Accounting Standard for Business Enterprises (MOF, 1997) specifies that Chinese-listed companies are mandated to disclose various details of their related enterprises as well as the types and amounts of all their related-party transactions in the notes to financial statements. However, it does not explicitly require listed companies to disclose the transfer pricing policies and methods of their related-party transactions. Therefore, the disclosure of transfer pricing methods is a voluntary management decision in China; managers can choose to disclose or not disclose transfer pricing methods in the notes to financial statements.[2] This offers us an excellent setting to investigate managers' decisions on transfer pricing disclosures.

In particular, we aim to examine whether the voluntary disclosure of transfer pricing policies is associated with earnings management incentives and governance structure. We argue that independent directors and institutional shareholders can help to monitor the management's decisions and lead to more voluntary disclosures of transfer pricing methods. Conversely, management is less likely to voluntarily disclose transfer pricing information if it manages earnings by manipulating transfer prices of related-party transactions and anticipates negative consequences (costs) of disclosing such information to stakeholders. The findings support our hypotheses and suggest that firms with a higher percentage of independent directors are more likely to voluntarily disclose the pricing details of their related-party transactions. Moreover, we find that firms with a higher percentage of government ownership are more likely to voluntarily disclose transfer pricing methods. This finding is consistent with the view that government-owned companies are more likely to make voluntary disclosures to reduce adverse selection problems. However, we find no significant association between institutional ownership and voluntarily disclosures of transfer pricing methods. Regarding the earnings management incentives, we find that firms with a higher level of earnings management resulting from related-party transactions (measured by abnormal related-party transactions) are less likely to voluntarily disclose transfer pricing methods. Our empirical results further suggest that managers who boost earnings to increase their bonuses or to meet earnings thresholds are less likely to engage in voluntary disclosures of transfer pricing methods. These results are robust in controlling for the type of goods being traded, tax effects, audit quality, and various firm characteristics (e.g., profitability, leverage, volume of related-party sales, capital needs, size, and growth) as well as the industry and year effects.

In addition to investigating voluntary disclosure decisions, we conduct supplementary analyses to test the firms that are more likely to be disciplined by the Shanghai Stock Exchange or the China Securities Regulatory Commission (CSRC) for noncompliance with applicable mandatory disclosure

[1] As Suijs (2005) argues, the existence of mandatory disclosure regulations suggests that firms are sometimes motivated to withhold private information from the public.

[2] Our sample includes firms that choose to disclose their transfer pricing methods (about 68% of observations) as well as firms that choose not to disclose them (about 32% of observations).

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