Advances in Accounting, incorporating Advances in International Accounting 26 (2010) 134–141

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Value relevance of disclosed related party transactions

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ARTICLE INFO

Keywords:
Value relevance
Related party transaction
Earnings management
China's stock market

ABSTRACT

Several recent North American corporate scandals have brought attention to the potential for accounting manipulations associated with related party transactions (RPTs), which have lead to a decline in perceived earnings quality. We examine the value relevance of disclosed RPTs in Chinese corporations. We focus on two types of RPTs: sales of goods and sales of assets. From 1997 to 2000, we find that the reported earnings of firms selling goods or assets to related parties exhibit a lower valuation coefficient than those of firms in China without such transactions. This result is not observed during 2001–2003 after a new fair value measurement rule for RPTs came into effect. Our evidence suggests that the new RPT regulation in China is perceived to be effective at reducing the potential misuse of RPTs for earnings management purposes. Since RPTs have been the subject of numerous scandals in North America, our evidence from the Chinese stock markets suggests that new RPT accounting standards could prove an efficient solution to this issue.

1. Introduction

This paper investigates whether disclosures about related party transactions made by listed firms are value relevant. Recent scandals in the United States, such as Adelphia and the Riga family's corporate group, and Hollinger and Conrad Black's corporate group, have brought related party transactions under the spotlight. Related party transactions have also received attention in China, as China has adopted two related party transaction standards over the last ten years, making the examination of pre-post standard effects possible.

Many Chinese listed companies are spin-offs of state-owned companies. Some companies are members of business consortia. Other related parties exist as a result of mergers and acquisitions or other capital investment activities. One view of the world is that related party transactions can be used within these corporate groups as a way to optimize internal resource allocation, reduce transaction costs, and improve return-on-assets. On the other hand, these transactions, if used opportunistically by management or other stakeholders, can produce misleading operating results and adversely affect minority shareholders' wealth. Many articles in the Chinese financial press express concerns about the widespread use of related party transactions (e.g., Huang, 2003; Cao, 2003). For example, they are worried about controlling shareholders using listed firms as financing vehicles and then reallocating listed firms' capitals to other ventures. Another worry is that management may be inflating earnings to gain rights issue approval through wash sales with related parties. Management may also be seeking benefits through buying and selling at unreasonable prices, or through the exchange of assets with different qualities, etc.

Responding to public concerns about the reporting of related party transactions, the Ministry of Finance of China (MOF), which is China's accounting standard setter, has first required listed firms to disclose related party relations and related party transactions to protect individual investors' rights in 1997. However, though Chinese listed companies were required to disclose their related party transactions, the MOF believed that some firms still engaged in these inter-company transactions to manipulate earnings and to mislead investors. By the end of 2001, the MOF promulgated another regulation that put restrictions on the accounting for related party transactions: *Provisional Regulation on the Accounting for Sales of Assets and Other Transactions between Related Parties* (labeled as "2001 RPT Measurement Regulation"). The new regulation states that if the price of a related party transaction is above its fair value, the price differential cannot be recognized as current earnings.

In this study, we investigate whether disclosed related party transactions under the new regulation in 2001 provide value relevant information to investors. We posit that if the new regulation is effective and related party transactions cannot be used opportunistically to manage earnings, there is little reason for investors to discount firms involved in related party transactions. Between 1997

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doi:10.1016/j.adiac.2010.02.004

and 2000, the MOF argued that related party transactions continued to be used to manipulate earnings. Hence, if investors are aware of the existence of the potential for earnings manipulation through these related party transactions, they would have reacted by lowering their valuation of firms that engage in related party transactions in the 1997 to 2000 period. First, we empirically examine whether disclosures of related party transactions provide value relevant information to investors in a regime where a fair value measurement standard does not exist. Second, we examine whether a fair value measurement requirement for related party transaction, following the adoption of the new regulation by MOF, changes investors' perceptions on the reliability of related party transactions information. Our test is based on a comparison of investor's valuation parameters for accounting fundamentals in valuing the firm, by comparing value relevance of related party transactions in China under both regulation regimes. We predict that the earnings parameter of firms that have related party sales transactions (including sales of goods and sales of assets) is significantly lower than that of firms without such transactions before the adoption of the "2001 RPT Measurement Regulation". Provided that the "2001 RPT Measurement Regulation" reduces the potential for earnings management, we predict that the valuation parameter of firms with related party transactions after this regulation is not significantly different from the valuation parameters of firms without related party transactions. If the regulation has successfully curtailed the use of related party transactions to manage earnings, then investors no longer need to discount the earnings of firms engaging in these transactions.

We collect data for 52 manufacturing firms that are part of the "Top 100 Chinese listed firms", as compiled in the "2002 Rankings" of *New Youth Fortune*, a Chinese financial magazine, and for which financial statements and stock market information are available. The accounting data cover the period 1997 to 2003. We divide our 297 firm-year observations into two test periods: 1997 to 2000 and 2001 to 2003. The partition point is the year 2001 when the "2001 RPT Measurement Regulation" has been issued. We perform regression analyses on sub-samples from these two test periods. Our results show that earnings of firms that have related party sales transactions (sales of goods and other assets) are less value relevant compared to the earnings of firms that do not engage in such transactions during the period of 1997-2000. However, there is no significant difference in the earnings valuation for the two groups in the second test period. These results suggest that the "2001 RPT Measurement Regulation" is perceived effective by investors at controlling opportunistic earnings management behavior by managers. In general, our results are robust to several sensitivity analyses.

This study contributes to the accounting literature in two ways. First, it expands value relevance tests from traditional financial statement numbers to related party transactions, which include information disclosed in the financial statement notes. We provide evidence that related party transactions information is used by investors to assess the reliability of reported accounting numbers for valuation purposes. Second, the research also contributes to the earnings management literature. We provide evidence that is consistent with the scenario that earnings management through related party sales is perceived as an opportunistic behavior in the Chinese stock markets.

Our empirical evidence also provides implications for Chinese accounting standard setter and other standard setters worldwide, who are concerned with related party transaction reporting, and their impact on firm value. For example, the events of Enron, Hollinger, and Adelphia suggest that we should also pay more attention to related party transactions in the North American stock markets. Our evidence suggests that increased disclosure requirements as well as a fair value measurement standard for related party transactions, as adopted in China, could prove useful.

The remainder of this paper is organized as follows. Section 2 introduces the related party transaction accounting standards adopted in China. The hypotheses are developed in Section 3. Section 4 describes the sampling process and the research model. Section 5 presents the results. Additional tests are summarized in Section 6. We conclude this study in Section 7 with closing remarks for future research.

2. Institutional background

Chinese mainland securities markets consist of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), which commenced operations in December 1990. The Chinese Securities Regulatory Committee (CSRC), an institution equivalent to the Securities and Exchange Commission (SEC) in the U.S., was set up in the following year to monitor and regulate Chinese stock markets. With the development of stock markets and the transformation of its economy, the Chinese government also initiated an accounting standard reform in the early 1990s. The Ministry of Finance (MOF) is empowered to set Chinese accounting standards.

In 1997, the MOF promulgated its first detailed accounting standard on related party transactions: *Disclosure of Related Party Relationships and Transactions* (labeled as "1997 RPT Disclosure Standard" hereafter). As CSRC requires listed firms to prepare financial reports in accordance with existing accounting standards, this standard applies to all publicly traded firms.

The "1997 RPT Disclosure Standard" defines the following agents as related parties (Ministry of Finance People's Republic of China, 1997):

1. Two (or more) companies where one directly or indirectly controls, or is controlled by the other, and two (or more) companies that are under common control with a company;
2. Joint ventures;
3. Associated companies;
4. Major investment individuals, key managers or their close family members;
5. Other companies that are directly controlled by major investment individuals, key managers or their close family members.[5]

A related party transaction is defined by the MOF as an event where a resource or an obligation of an entity is transferred between related parties, whether or not a monetary consideration has been received. This standard provides the following examples of related party transactions: (1) purchase or sales of goods; (2) purchase or sales of assets other than goods; (3) provision or acceptation of service; (4) agency; (5) leasing; (6) provision of capitals (including loans or equity capitals in forms of cash or physical assets); (7) guarantee and mortgage; (8) management contract; (9) transfer of research and development projects; (10) license agreement; and (11) compensation of key managers.

The regulator did not perceive that the "1997 RPT Disclosure Standard" was a sufficient tool to eliminate the earnings management behavior of listed companies. At the end of 2001, the MOF issued a regulation about the accounting measurement of related party transactions: *Provisional Regulation on the Accounting for Sales of*

[5] The "1997 RPT Disclosure Standard" does not apply to the following potentially related parties:

a. Fund providers, public utilities, government departments and institutions which have normal operational transactions with a company but do not have other related party relationships, although they might be involved in a company's financing and operating decisions, or confine the firms' activities to some extent;
b. Individual buyers, providers or agents who have business dependencies with the company just due to a large amount of transactions;
c. State-owned companies are not related parties just because they are all controlled by the state, but they are related parties if they have the above mentioned related party relationships defined in the standard.