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Effect of disclosure regulation on earnings management through related-party transactions: Evidence from Taiwanese firms operating in China

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A B S T R A C T

This study examines the effect of disclosure regulation on earnings management using Taiwanese companies conducting transactions with China as the institutional setting. Measuring earnings management by the amount of discretionary accruals (DACCs), the study shows that disclosure regulation mitigates DACCs of Taiwanese firms engaging in related-party transactions with Chinese entities. Following enactment of the disclosure regulation in November 2000, DACCs among Taiwanese enterprises conducting transactions via offshore affiliates dropped. While the disclosure regulation helps to reduce earnings management, this study reports that such effect is asymmetric between high-tech firms and non–high-tech firms. Specifically, the disclosure regulation is effective in reducing earnings management among firms in non–high-tech sectors. However, such effect is not significant among firms in high-tech sectors. This study discusses the implications of empirical findings for corporate management, regulatory agencies, and firm stakeholders.

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1. Introduction

Political concerns and economic anxiety can give rise to new regulations. Adopting the political cost hypothesis, Watts and Zimmerman (1986) suggest that firms may manage earnings when targeted by regulatory actions. Following this argument, the literature indicates that management may arrange transactions through related parties to conceal business activities from government agencies to mitigate the adverse effect of regulations on firm operations (Jian and Wong, 2010; Kohlbeck and Mayhew, 2010). Because of the low transparency and the sophisticated nature of related-party transactions (RPTs), firms have opportunities to manipulate reported earnings.

Since RPTs may not have occurred or may have occurred on different terms with arm's length parties, the primary course of action that government can take toward enterprises is to regulate RPTs. As Shaffer (1995) indicates, regulatory interventions in business activity are relatively prevalent because governments around the globe have long abandoned laissez-faire economic policy (Shaffer, 1995). Using Taiwanese firms operating in China as the institutional setting, this study contributes to the accounting literature by examining the effect of disclosure regulation on earnings management. This setting is selected because the Taiwan government has enacted laws and regulations to slow down Taiwanese enterprise investments and operations in China.[3] The purpose of these actions is to mitigate the economic and political anxiety among the public in Taiwan, since people have become increasingly concerned over their economic dependency on China and the potential effect of such dependency on Taiwan's political autonomy. Because government controls over business activity could have adverse effects on firm performance, many Taiwanese firms have established offshore affiliates, as related parties, and conduct transactions with their Chinese counterparts through these affiliates to moderate the economic consequences of government regulations. As in other forms of RPTs,[4] conducting transactions through offshore affiliates provides opportunities for corporate executives to manage earnings. Hence, the quality of financial statements declines (Healy and Wahlen, 1999; Gordon et al., 2005).

To strengthen regulation over Taiwanese enterprises' business activities in China, Taiwan's government enacted a disclosure regulation in November 2000 that requires Taiwanese firms to report their investments and transactions with Chinese entities through related parties. To investigate the effectiveness of the disclosure regulation, this study examines whether earnings management among firms engaged in RPTs through their offshore affiliates with Chinese entities has decreased since promulgation of the regulation. Further, this study explores whether disclosure regulation would be more effective in mitigating earnings management among firms in non-high-tech industries than those in high-tech industries. Using the amount of discretionary accruals (DACCs) as a proxy for earnings management, this study finds that the disclosure regulation effectively reduces the DACCs of Taiwanese firms engaging in RPTs with Chinese entities. While the promulgated disclosure regulation helps to reduce overall earnings management among studied firms, it is more effective in reducing the amount of DACCs of firms in non-high-tech industries than in high-tech industries.

This study proceeds as follows. Section 2 describes the political background between Taiwan and China and discusses the uncertainties encountered by Taiwanese firms investing and operating in China. This section also highlights the key aspects of the disclosure regulation and connects it to earnings management. Section 3 reviews the literature in earnings management and outlines the relations between government regulations, RPTs, and earnings management. Section 4 develops the research hypotheses. Section 5 describes sample selection procedures and presents the regression models. Section 6 reports the empirical results. Section 7 describes robustness tests and presents the results of

[3] Taiwanese enterprises began to invest in China after 1988, after the Chinese government began to allow the Chinese exiles of 1949 to visit their relatives in China. With increasing investments in China, many policies emerged to slow down these activities. For instance, investments made by Taiwanese high-tech firms in China became highly regulated after former Taiwanese president Teng-Hui Lee made a political declaration of cross-strait relations on September 14, 1996. Moreover, investments exceeding US$50 million made by Taiwanese firms in China, regardless of the industry or the nature of the investment, requires official approval from a government agency.

[4] Although a number of definitions exist, RPTs are generally defined as transactions between a firm and related entities such as affiliates, subsidiaries, principal owners, officers, and corporate directors (Gordon et al., 2005, 2007).