WHAT AFFECTS RELATED PARTY TRANSACTION?

“Evidence from Public Listed Companies in China and the U.S.”

(Unfinished)

Supervisor: Torbjörn Tagesson

Authors: Shanshan Zhou
          Xiyue Zhang
# Table of Contents

Part I. Introduction .............................................................................................................. 3

Part II. Methodology ......................................................................................................... 7
  2.1 Research philosophy ................................................................................................. 7
  2.2 Research approach ................................................................................................... 7

Part III. Institutional background .................................................................................... 10
  3.1 Institutional background of China ............................................................................. 10
  3.2 Institutional background of the U.S. ......................................................................... 12
  3.3 Why are China and the U.S. ideal for this study? ...................................................... 13

Part IV. Theory ................................................................................................................... 15
  4.1 Corporate governance and RP transactions ............................................................. 15
  4.2 Earnings Management and RP Transaction ............................................................. 16
  4.3 Theory Framework ................................................................................................... 17
  4.4 Hypothesis ................................................................................................................ 19
    4.4.1 Size .................................................................................................................. 19
    4.4.2 Debt ratio/Leverage .......................................................................................... 20
    4.4.3 ROE .................................................................................................................. 20
    4.4.4 Corporate Governance Variables ...................................................................... 21
    4.4.5 Industry ............................................................................................................. 21
    4.4.6 Property of holdings .......................................................................................... 22

Part V. Empirical research .................................................................................................. 22
  5.1 Data .......................................................................................................................... 22
  5.2 Sample ...................................................................................................................... 23
  5.3 Variables .................................................................................................................. 23
    5.3.1 Dependent Variable ......................................................................................... 23
    5.3.2 Independent Variables ...................................................................................... 24

Part VI. Analysis and discussion ....................................................................................... 24

Part VII. Conclusion .......................................................................................................... 24

Reference ............................................................................................................................ 25
Part I. Introduction

Due to the profound influence on accounting area created by the scandals in the United State such as Enron, Adelphia, Riga family's corporate group and the examples of abusing RP transactions during the period of Asian financial crisis from 1997 to 1998, the topic of RP transactions (hereafter RP transactions) has tended to be more worthy of researching. In this study, we examine the significant factors that will influence the occurrence of RP transactions using two sets of listed company samples from China and the US.

RP transactions are prevalent especially for group firms in the business world. According to International Accounting Standard 24, a RP transaction is defined as a transfer of resources, services or obligations between a reporting entity and a RP, regardless of whether a price is charged (IFRS, IAS 24, A683). The classical types of this kind of transactions include purchases or sales of goods or other assets, rendering or receiving of services, leases, transfers under finance arrangements, provision of guarantees or collateral, (IFRS, IAS 24, A686) etc. Although the definition of this type of transaction is confined, researchers hold divergent opinions on its function in a firm.

For instance, Fisman and Khanna (2004) point out that group firms can take advantage of RP transactions to allocate resources effectively, obtain internal financing opportunity, diversify risks and achieve other accounting profits. Fan and Goyal (2002) also mentioned transactions cost theory to demonstrate the positive impact of RP transactions to deal with asset specificity and reduce uncertainty of transactions in market. Other authors such as Kim (2003), Shin and Park (1999), Hu and Li (2010) express similar point of view and refer RP transactions to common business activities aiming to reduce transaction costs, achieve tax avoidance, improve operating efficiency, coordinate business strategy and create competitive advantages.
However, RP transactions can be implemented by controlling shareholders or managers as a tool to manipulate earnings or conduct other opportunistic activities to maximize self interest. Listed firms implement abnormal related sales, lending and other mechanisms to inflate earnings and encroach the interests of small shareholders. Meanwhile, RP transactions also get involved into the issue of fraudulent financial reporting which will mislead the external investors to a large extent (Henry et al., 2006; Jian and Wong, 2008). Accordingly, the response from markets to such transactions is to regard at least some of them as opportunistic instead of normal mechanisms to improve operating efficiency (Jian and Wong, 2003). In this way, the volume of firms with RP transactions are usually lower than those without such kind of transactions as a result of mistrust from markets (Kohlbeck and Mayhew, 2009; Gordon et al., 2004).

What is noteworthy is that RP transactions are not only prevalent in emerging or transition economies such as China, India and other developing countries. As mentioned in the beginning of the paper, firms in developed countries like the US, UK and other European countries also take advantage of it to enrich controlling owners maybe just in a more sophisticated way (Jian and Wong, 2003).

Because of the threat of earnings management by inducing RP transactions to the accounting information credibility and quality, accounting standard setters have paid high attention to this issue and launched a series of regulations to restrict such malpractices. For example, International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have issued IAS24 and FAS57 respectively to clarify the requirements on disclosure of RP transactions. Ministry of Finance (MOF) in China produced China Accounting Standards (CAS) 36 to provide guidelines for listed companies in China to follow. The relating items in these standards are modifying continually to coordinate with new practical needs. The latest version of IAS24 was issued in November 2009 and it has to be complied with from 1 January of this year (IFRS, IAS 24, A677). The specific regulations in China and the US will be displayed later in the section of background since the researching
samples are focused on these two countries.

Basing on the discussion above, it is of great significance to identify the determinants of RP transactions in order to effectively mitigate the negative impacts on investors and capital markets caused by them. Some prior studies have associated RP transactions with corporate governance or earnings management. Several internal governance factors such as ownership structure, CEO duality, proportion of outside directors (Hu & Li, 2010) and some other certain characteristics of firms like size and industry can be used to explain the variation of implementing RP transactions. There exists some overlap between the above factors and the incentives of earnings management if part of RP transactions (e.g. abnormal RP transactions) were treated as means of managing earnings. Motivated by the former researches we integrate both factors of corporate governance and incentives of earnings management to assist us finding out the significant determinants.

The uniqueness or value of our research needs to be elaborated here. Most prior researches in this area attempted to study RP transactions from aspects of corporate governance and/or earnings management. There is little evidence or discussion about what factors could affect firms’ value of RP transactions. Besides, in contrast to prior studies focusing solely on RP transactions within certain single country, this paper selects two samples of companies from China and U.S., and studies these two samples. The underlying reason is that the two countries have rather different economic and social situations. China is a socialist country with developing economic, underdeveloped financial market and great amount of state owned companies. On the contrast, U.S. is a capitalism country with highly developed economic, active and mature financial market, and most large entities private-owned. The two countries also have different accounting standards of treatment on RP transactions. And some of these standards even have been implemented may not function well. All of these are also considered in our study in order to get a more reliable conclusion. Comparing evidences generated from the two independent studies about RP transactions in such two different countries, we get some general rules that may
explain the value of firms’ RP transactions.

This study aims to find out the factors that could affect a firm’s value of RP transactions considering different social situations, extent of economic development and other culture factors. In order to remove the possible effects from social and economic factors and to find some general rules, we perform two separate studies basing on two samples selected from two countries that vary significantly: China which stands for the emerging markets and U.S. which stands for the developed markets. By comparing and analyzing the two sets of results we generate from the two samples, we conclude some explanations for the differences in volume of RP transactions between firms each year.

The remaining part of this thesis is arranged as follows. Part two briefly describes the methodology of our study. In part three, we would like to introduce the institutional background related to RP transactions in China and the US. Thereafter is part four which documents the theoretical framework and hypotheses developed on the basis of the framework. Part five describes the process of collecting data and selection of variables. Next, in part six, the results and analysis of this study are provided. Finally, section seven is to show the conclusion and implications for future research.
Part II. Methodology

2.1 Research philosophy

Considering our aim of this study is to figure out the factors which have significant influences on RP transactions, we decide to take positivism paradigm as our research philosophy. Initially developed by Auguste Comte in the early 19th century and later formally established as a critical research method by Vienna Circle in the early 20th century, positivism has become a philosophical attitude towards the knowledge accumulated by humans (Kolakowski, 1972). This paradigm holds the idea that we can observe real events through empirical researches and generate knowledge by logical analysis (Kaboub, 2008). Moreover, from positivistic perspective, the results derived from research can be generalized (Emnert and Johansson, 2010). We will take advantage of this philosophy and attempt to generalize our findings of empirical research to invest them with practical significance.

2.2 Research approach

It is possible to implement qualitative or quantitative approaches in empirical studies. As for this specific study, we conduct a quantitative approach instead of a qualitative one. Quantitative research focuses on quantifying and analyzing the data that have been collected with a purpose to test the theory; while on the other hand, qualitative research pays more attention to words and aims to generate theory (Bryman and Bell, 2007). Additionally, our aim of this study as mentioned before has carried the implication for method selection. This statement has been supported by Punch (2005), said that ‘factors which affect’, ‘variables’ possessed an implication of quantitative method. The data collected by us are numbers instead of words; therefore, a quantitative research is more appropriate for us to answer the question we raised in this study.

In addition to quantitative approach, deductive approach is also selected by us to assist our research. The key process of deductive approach is from theory to findings
or observations (Bryman and Bell, 2007). This kind of process is treated by Hyde (2000) as a theory testing process aiming to check the applicability of some certain theories towards empirical situations. Given the issue of our study is similar to explaining an empirical phenomenon, namely the usage of RP transactions, certain theory is needed for us to support our expectations of rational explanations prior to the actual empirical research. Therefore, deductive reasoning process seems to be more consistent with our research issue. There is a figure depicting the process of deduction presented in study of Bryman and Bell and we decide to incorporate it into this study as shown below in Figure 1. Our research process commences with development of hypotheses based on selected theories, and then collects data of RP transactions volume in both samples. Thereafter, the findings derived by using data processing mechanisms will be treated as evidence to determine the validity of previously selected theory.

The process of deduction

In general, inductive approach, as a counterpart of deductive approach, is of popularity in research area. Its reasoning process is just opposite to deductive pattern starting from findings or observations to theory (Bryman and Bell, 2007). Due to the difficulty of covering all relating observations and the demands of theoretical support to precede empirical research, inductive reasoning does not fit for this study.
Overall, under the research philosophy of positivism paradigm, we follow both quantitative and inductive approaches to conduct our research.
According to 2010 data, China (Special Administrative Regions of Hong Kong and Macau, and Taiwan not included) has a GDP of 5,878 billion and ranks as the world’s second largest economy only after the United States, which has a GDP of 14,657 billion, approximately a quarter of nominal global GDP. (IMF, 2011) As the two largest world’s leading economies, China and the United States vary significantly from all aspects.

3.1 Institutional background of China

China, as the largest emerging economy, has increasing impact worldwide. It has a unique context, with a one-party authoritarian political system, central-controlled economy, and high state ownership of business companies (Bewley and Peng, 2008). Besides; business groups are of prevalence in China (Jian and Wong, 2003). All of these characteristics make China a proper choice for us to conduct deeper investigation on this issue.

The official term for Chinese economy system is the socialist market economy with Chinese characteristics. During past 30 years, with average growth rates of 10% achieved, China stays the world’s fastest-growing economy. Nevertheless, it remains as a developing country with a one-party authoritarian political system. Economic freedom and political freedom or democracy, have a strong correlation with each other. The higher the political freedom is, the more positive impact on economic freedom, vice versa (Miller, 2011).

In 1949 when the new government was founded, China followed the socialist political system. In the 1950s, Chinese economic system was the centrally planned economy. Nearly all the domestic companies were owned by the government. Those state-owned enterprises followed every single instruction of the state, from annual production plans to the prices of key commodities. Since 1978, after ten-year’s
culture revolution, China has instituted its free-market reform. This economic transformation resulted in unprecedented economic expansion (Chen and Feng, 2000). The role of the government in the economy had greatly lessened (Perry and Wong, 1985), changing from control to “guide” (China’s State Constitution of 1982, 1982). The State Constitution of 1982 defined that the state is to guide the country’s economic development by making broad decisions on economic priorities and policies. Though the government maintained a major role in managing the economy and most important industries, private-owned companies and market played more and more independent role in a range of activity. (Gao, 1996). Overall, the Chinese industrial system in 1980s contains a complex mixture of relationships. (Hsu, 2007)

After 1992, China gradually transformed to socialist market economy model. SOEs remained major hurdles for its economic development. According to a report by Chen and Feng (2000), from 1978 to 1994, the total value of the output produced by collective owned companies increased by 820% which was approximately 8 times as that by the SOEs, and the average annual growth rate by SOEs was 4.9%, compared to 14.9% by collectively owned companies. For some SOEs, situation was even worse. They continued to lose money (Chen and Feng, 2000). In September 1997, President Jiang Zemin announced the plan to sell, merge, or close the vast majority of SOEs with the aim to increase non-public ownership (which was known as privatization). According to National Bureau of Statistics (NBS, 1995, 2005), the number of Chinese SOEs in large and medium-size industry fell from 15 107 in 1995 to 3999 in 2005.

During the 1990s, China made impressive economic growth; however, this socialist market economy model distinct a lot from the Western market economy model. The fundamental difference is the political philosophy, which eschews the notions of democracy, individual rights, but considered to be authoritarian. And during the past ten years, despite the high growth rates in GDP it has achieved by implementing such model with high development potential, China commits to the one-party centralized control (Yu, 2010).

The other obvious difference remains in the number of SOEs. Though the
market-oriented reforms have been taken place for three decades, SOEs still have a dominant position in the Chinese economy. In 2005, there were 3999 SOEs in all large and medium-size industry, which represent 25 percent of the total. Those SOEs centralized RMB6090 billion assets (59 percent of the total), and earned a total profit of RMB268 billion (48 per cent of the total). (NBS, 2005, Geng, Yang, & Janus, 2009) However, privately owned enterprises, as a major component of the new Chinese economic system, are becoming more and more important. In 2010, there were at least 10 million small private-owned firms running business in China. (Batson, 2010)

### 3.2 Institutional background of the U.S.

U.S. has been the world's largest national economy since the 1870s. (Maddison, 2006) It has one of the world's largest and most influential financial markets, the largest and most active stock exchange in the world: the New York Stock Exchange, and many other major stock and commodities exchanges like NASDAQ, AMEX, CME, and PHLX. It is also the home for 139 of the global 500 largest corporations, far exceeding that of any other country, and all of these corporations are private owned. (Fortune, 2010) A main character of the U.S. economy is the economic freedom provided to the private sector by allowing the private sector to make the majority of economic decisions in determining the direction and scale of what the U.S. economy produces. This is enhanced by relatively low levels of regulation and government involvement, as well as a court system that generally protects property rights and enforces contracts. (Anderson, 2006)

Compared to China, U.S. does not have so many SOEs and its market is considered as being more transparent and free. However, there are similarities lying between the two markets, especially in their policies tendency.

Protectionism in China for domestic enterprises and especially SOEs is obvious, primarily by legislation. The Government Procurement Law stipulates that government procurement should purchase domestic commodities, engineering, and service (Article 10) and should be favorable for the national strategic goals of
economic and social development (Article 9). (China’s Government Procurement Law, 2002) The Administrative Regulation on the Government Procurement of Innovation Products implemented in 2007 also gives priority to domestic independent innovation products. (China’s Administrative Regulation on the GP of IP, 2007) The government also sets certain market access and trade barriers for foreign invested enterprises (FIEs) in China, such as the strict restrains in Catalogue Guiding Foreign Investment in Industry. According to the 2010 member priorities survey by the US-China Business Council, FIEs in China pay more and more attention to the direction of national and local policies. One of their most concerned problems is the unfair competition with Chinese SOEs and other famous private companies. The survey also addresses that Chinese government achieve its protectionism by applying “subtle measures” in the economy. (USCBC, 2010) Such protectionism is more and more severe in U.S. as well. The United States suffered a lot in the nearest global financial crisis both economically and politically. Firms went to bankruptcy, people lost jobs, exports reduced, and as a super World Power, U.S.’s international influence has been reduced. In September 2009, in order to protect its domestic tyre producers, U.S. decided to impose a 35 percent tariff on imports of Chinese tyres which had highly competitive price in U.S. market (Dyer and Braithwaite, 2009). Though the U.S. market is relatively more mature and diversified, it is still not a totally free market.

3.3 Why are China and the U.S. ideal for this study?

The economic institutions of a country could determine its companies’ accounting properties (Ball et al. 2000; Leuz et al. 2003; DeFond et al. 2007). For the study of RP transaction and earnings management, emerging market has its advantage. Prior researches indicate that RP transaction and earnings management are more severe in emerging economy (Leuz, Nanda and Wysocki, 2003; Krishnamurti, Aleksandar and Zeljko, 2005; Liu and Lu, 2004, 2007; Jian and Wong, 2008). And it is believed that the inherent relationship between RP transaction and earnings management are more pronounced in emerging economy like China (Liu and Lu, 2004, 2007).
regulatory authorities like the China Securities Regulatory Commission (hereafter CSRC) regulate China's stock market in an “administrative governance” approach (Pistor and Xu, 2005). Companies have to meet the required minimum return on assets (hereafter ROE) for three consecutive years before initial public offering (hereafter IPO), as required in CSRC’s Notice. According to Article 157 of China’s Company Law, CSRC will de-list those public listed companies which keep losing for three consecutive years. All of these regulation practices lead to strong incentives of companies to manage earnings (Liu, 2005; Jian and Wong, 2008).

U.S. is considered to have the strictest rules regarding the preparation of financial reporting. Companies in U.S. provide the highest volume of information (Dechow and Schrand, 2004). The market seems to be a safe place for investors and other shareholders. However, many of the most shocking financial scandals happened here. Among all those scandals, Enron, a most famous case, achieved its fraud by special-purpose entities (SPEs), which enabled it to keep billions of debt off its balance sheet (Benston and Hartgraves, 2002). This could be considered as an illegal use of RP transaction, as most of the SPEs are related party to the company. According to U.S. General Accounting Office (2003), RP transaction was identified as one of the nine main reasons that lead companies to restate financial statements.

All in all, the two large world powers are both the perfect choice for the research of RP transaction and earnings management, and at the same time are no doubt a sharp contrast, which we believe could contribute to our study of RP transaction in different context, despite some similarities including protectionism which is commonly aware.
Part IV. Theory

Before demonstrating our theory framework, some prior researches focusing on the aspects of association between corporate governance, earnings management and RP transactions will be reviewed first.

4.1 Corporate governance and RP transactions

Corporate governance is important for investors to guarantee that they will obtain the returns of investments they deserve (Shleifer and Vishny, 1996). The mechanisms of corporate governance are closely related to economic and legal intuitions (Shleifer and Vishny, 1996) and can be divided into internal and external types (Liu and Lu, 2007). Internal mechanisms which are confined inside of firms comprise independent board of directors, managerial compensation, dispersed ownership structure and disclosure of relevant information while external mechanisms include corporate control markets, a proper legal infrastructure and developed capital markets (Liu and Lu, 2007; Cuervo, 2002). Both of these mechanisms are implemented to mitigate the agency problems due to the separation of ownership and control. Looking backwards, it is still difficult for us to distinguish between good and bad corporate governance systems even in the developed economies. For instance, some researchers treat the US corporate governance system as perfect or even the best one in the world (Easterbrook and Fischel, 1991; Romano, 1993) while some others point out some weaknesses in the US system as opposing standpoints (Jensen, 1993; Shleifer and Vishny, 1996). The situation in immerging economies, for instance, China is even less optimistic since the underdeveloped capital markets and relatively lagging institutional support. Therefore, investigating the impacts of corporate governance mechanisms on RP transactions have some practical implications.

According to agency theory, motivated by self-interest, there exist conflicts between managers and owners along with information asymmetry (Huang and Chang, 2009).
On the other hand, as mentioned by Jian and Wong (2003), the agency problems have been extended to the disharmony between controlling shareholders and minority shareholders. The risk of minority shareholder expropriation has been related to the RP transactions and the power of controlling shareholders tends to be larger. Additionally, in the study of Porta et al. (1999), they identified the ultimate ownership structure of 27 wealthy economies in the world and find that most of the firms are controlled by families or the state instead of widely-held or dispersed type of structure. This phenomenon possesses characteristic of prevalence and covers both developed economies (e.g. the US) and emerging economies (e.g. China). Therefore, the typical centralized ownership structure probably tends to create increasing opportunities for controlling shareholders to manipulate earnings through RP transactions.

From the perspective of most researchers, the formulation of corporate governance system does impact the occurrence of RP transactions. Among several other mechanisms, ownership structure is a key factor to influence the volume of RP transactions (Hu and Li, 2010; Jian and Wong, 2008). In accordance with the study of Gordon et al (2004), the volume of PR transactions is higher in corporations with weaker corporate governance mechanisms. Generally speaking, prior relating researches have focused on detecting the relationship between corporate governance mechanisms and RP transactions which also motivate us to conduct this study.

4.2 Earnings Management and RP Transaction

As defined by Schipper (1989), earnings management is ‘purposeful intervention in the external financial reporting process with the intent of obtaining private gain’. In the study of Dechow and Schrand (2004), they illustrate two major ways of managing earnings: manipulation of real transactions and manipulation of accruals. On the one hand, managers can manipulate cash flows by reducing expenditures or increasing discount sales (Dechow & Schrand, 2004). Although this kind of behavior is not a violation of accounting standards (e.g. US GAAP); it will negatively affect earnings
quality and subsequently undermine the validity of financial information. On the other hand, managers may manipulate accruals instead of real transactions to achieve their desired earnings. Certain actions like capitalizing costs, decreasing doubtful accounts, reducing assets write-offs can be divided into the second kind of earnings manipulation. The consequences of manipulating accruals are just similar to those of real transactions.

Another point which should be noted here is that according to the perspective of Peasnell et al. (2005), earnings management should include both income-increasing and income-decreasing behaviors. Increasing income activities are easy to understand while activities of decreasing income can also be explained by political cost theory aiming to avoid political attention.

In most studies relevant to RP transactions, RP transactions are usually treated as a mechanism of manipulating earnings especially by controlling shareholders to benefit themselves. For instance, Jian and Wong (2008) find out that in Chinese listed corporations, controlling shareholders take advantage of related party sales to manipulate earnings. Gordon et al. (2004) point out that RP transactions should be viewed as conflicts of interest between agent and principal rather than efficient transactions. Additionally, Johnson et al. (2000) even give RP transactions a terminology of ‘tunneling’ to present ‘transfer of resources out of a company to its controlling shareholder’. This ‘tunneling’ behavior can be supported by the study of Cheung et al. which concludes that through buying assets from related parties with a higher price and sell assets to related parties in a lower price compared to similar arms’ length deals, controlling shareholders transfer resources away from minority shareholders to benefit themselves.

Taking the above discussion into consideration, we would like to attach importance to the influence of RP transactions on financial information and take effort to clarify the fundamental causes of such opportunistic behavior.

4.3 Theory Framework

According to prior studies, we consider two situations in which companies might
employ RP transaction. One is to use RP transaction to reduce the transaction cost and lower tax burdens, especially in a market that is not mature or developed (Coase, 1937; Cook, 1977; Fisman and Khanna, 1998; Jian and Wong, 2003; Hu and Li, 2010). The other is to use it as a way of managing earnings in order to achieve companies’ management compensation, issuing-related, tax or other aims (La Port Lopez-de-Silanes, and Shleifer, 2000; Claessens and Fan, 2002; Liu and Lu 2004 and 2007; Jian and Wong, 2008; Hu, Shen, and Xu, 2009).

Positive accounting theory (or economic agency theory) can be used to explain companies’ intentions to conduct RP transaction. Watts and Zimmerman (1978, 1979, and 1986) pointed out that “contracting costs” are related to three corporate characteristics: firm size, debt ratio and bonus plan. Here, firm size is a proxy for political attention. On one hand, the larger a firm is the less profit it would like to report, in order to avoid or reduce political attention and political cost (Watts and Zimmerman, 1978, 1979, 1986). Under this hypothesis, companies might employ RP transaction to monopoly profits and to reduce cost. On the other hand, since firm size could proxy for many other factors (Ball and Foster, 1982), it might also relate to other factors that may affect companies’ using of RP transaction. The debt/equity hypothesis refers to how companies’ leverage effects the intention of managing earnings. The evidence shows that companies with higher debt/equity ratio are more likely to use methods that generate higher profits, since the higher its debt ratio the closer it is to the covenants constraints (Kalay, 1982, Duke and Hunt, 1990). The bonus plan hypothesis assumes managers (the agent) are self-interest and they own some discretion given by the principal. With such discretion, besides to maximize firm value, managers would tend to transfer wealth to themselves. So, managers who have bonus plan would choose method that gives higher current period profits.

Watts and Zimmerman’s choice study in 1986 found the same results with the hypothesis. An exceptional situation is “Big bath” or “Earnings bath” (Watts and Zimmerman, 1978, 1979, 1986, Dechow and Schrand, 2004). When the current
year’s earning is too low to meet the minimum requirement for bonus, manager will choose to reduce this year’s profit and leave it for the next year. Based on accruals, revenues and profits might be almost fixed. Hence, the incentive to increase or reduce reported profits could be realized by earnings management methods, to which RP transaction belongs.

Although Positive Accounting Theory is the main theoretical basis for this study, many other theories are of great importance. Since RP transaction is affected by many factors, it could be helpful to make good use of several theories as a whole. According to Gray et al. 1995 and Ljungdahl 1999, in order to explain an empirical phenomenon, looking upon theories as competitive rather than complementary could be a problem. Therefore, we took an eclectic approach (e.g. Neu and Simmons ,1996; Falkman and Tagesson, 2008, Collin et al., 2004,2009) and a multi-theoretical framework (Cormier et al. , 2005) in this study to exam the factors that affect RP transaction.

4.4 Hypothesis

4.4.1 Size

Research has shown that large firms are exposed to more political attentions, and tend to report lower profits (Watts and Zimmerman, 1978, 1979, 1986; Mutinellia and Piscitellob, 1997). RP transaction are mainly used to increase incomes and profits, hence, we propose the following hypothesis:

H1 There is a negative relationship between firm size and the total value of related party transaction.

However, size could proxy for many other factors besides political cost. The larger the size of a firm, the higher the total volume and the larger the total value of its annual transactions. From this aspect, we may assume the following correlation:

H2 There is a positive relationship between firm size and the total value of related party transaction.
4.4.2 Debt ratio/Leverage

According to positive accounting theory, companies with higher debt ratio have incentives to increase reported profit, which means a possibility of earnings management. Evidence also shows that a high debt ratio generates higher transaction costs, since debt suppliers have the opportunity to protect their interest by various contracts (Jensen and Meckling, 1976). By conducting RP transaction, companies could reduce transaction cost (Coase, 1937; Cook, 1977; Fisman and Khanna, 1998, Jian and Wong, 2003, Hu and Li, 2010). Hence, we could assume the following hypothesis:

H3 There is a positive relationship between debt ratio and the total value of related party transaction.

4.4.3 ROE

Considering the specific listing regulation in China we discussed before in the background, we include ROE for Chinese companies in this study. According to China’s Company Law, ROE has significant influence on unlisted companies’ IPO and whether listed companies have to delist or not. According to Notice 17 of CSRC (1996), companies must achieve minimum ROE of 10% for at least three consecutive years in order to public offer. In the modified Notice 12 of CSRC (1999), an average ROE of 10% and a minimum annual ROE of 6% in the three years before public offering are required. In 2001, this requirement was further modified to an average net ROE of 6% for the past three years before public offering. In 2002, CSRC again significantly increase this requirement to 10%. Besides, if a listed company keeps losses for two consecutive years, CSRC will allocate it to special treatment (“ST”) companies; if the company keeps losses in the third year, CSRC will temporarily delist it. Such regulation provides companies great incentives to manage earnings. As many prior studies proved, many Chinese listed companies employ earnings management methods in order to achieve the 10% requirement (Chen 1998; Jiang and Wei 1998; Chen et al. 2000b; Chen and Yuan 2004; Haw et al. 2005; Jian and Wong, 2008).
There is a negative relationship between company’s ROE and the total value of related party transaction.

4.4.4 Corporate Governance Variables

Many prior researchers examined the impact of corporate governance on earnings management, and found a negative relationship between them (Dechow and Schrand, 2004; Gordon, Henry, and Palia, 2004; Dignam, 2005). According to Lu and Liu (2007), the lack of effective corporate governance mechanism that could protect outsider and minority shareholders is an important reason leading to relatively more serious RP transaction in emerging markets. Good corporate governance limits controlling shareholders’ RP transaction activity (Leuz et al., 2003). If we assume that earnings management in listed companies is at least partly induced by RP transaction, we would expect the use of it to be correlated with a company’s corporate governance practice.

The study by Chen et al. (2006) provides further evidence that various aspects of corporate governance might influence companies’ financial frauds. According to Collin et al. (1998, 2010), corporate governance mechanisms which are effective in protecting minority and outside shareholders include: highly dispersed rather than centralized ownership structures, independent boards and outside directors, high-quality auditing, and active external takeover markets. In this study we examine the effects of ownership structures, compensation of outside directors, and audit firms. In line with prior theories and researches, we propose the following hypotheses:

H5 There is a positive relationship between the centralized level of ownership structure and the total value of related party transaction.

H6 There is a negative relationship between the level of compensation of outside directors and the total value of related party transaction.

H7 Audit firms might affect company’s use of related party transaction.

4.4.5 Industry
And empirical evidence shows that, in some specific industry, like the oil and gas industry, the relationship between firm size and the trend to manage earning are stronger (Zimmerman, 1983).

**H8** The use of related party transaction varies among different industries.

### 4.4.6 Property of holdings

(to be continued)

**H9** The state-owned companies involve more related party transactions than non state-owned companies.

---

**Part V. Empirical research**

#### 5.1 Data

Data collection is a key point to determine the success of quantitative empirical research. As introduced in the study of Hyndman (2008), there are several types of common data collection instruments such as Interviewer enumerated surveys, Web surveys, Mail surveys, Telephone surveys, Diaries and Archival data. Generally speaking, we can divide the several methods into two major categories: collecting primary data through surveys or using existing data which is also called second hand data. These methods possess both advantages and disadvantages for an empirical research; therefore we have to make a trade-off between these collecting instruments. Taking the factors mentioned by Hyndman (2008) including complexity of the topic, response rate required, budget of the research and targeted population into consideration, we decide to use secondary data to support our research. By
doing so, relatively large amount of data can be collected without spending too much time and money on it.

To find out the factors influencing RP transactions, a sizable data population is required. Our data is derived from two main sources: DataStream database and annual reports of listed corporations. We collect relating information of variables in question from the above two sources to enable the fulfillment of data requirement.

5.2 Sample

A qualified sample should be of the characteristics of both representativeness and stability. Sampling schemes can be in probability methods and non-probability methods. In non-probability samples, the probability of being selected for each unit is unknown while it is certain to know beforehand in probability samples (Hyndman, 2008). Regarding our data collection method, the sampling schemes in our study should be fallen into probability type. The specific sampling method we decide to use is Stratified Random Sample scheme which means dividing population into non-overlapping groups and then selecting a simple random sample from each separated group (Hyndman, 2008).

The sampling process is described as follows. First of all, we implement DataStream to collect variables like leverage (debt/asset ratio), total assets and ROE of listed corporations in China and the US. The searching work is conducted according to the sector groups divided by the database. All sectors existed in the database is included except for financial ones since financial corporations are quite different from non-financial corporations in doing business. Once the corporations with valid data are available involving 30 sectors, we select certain percent of corporations in each sector randomly and get our final sample population.

5.3. Variables

It is an important aspect of our study to determine the independent and dependent variables.

5.3.1 Dependent Variable
In order to measure RP transactions, we use annual value of RP transactions disclosed in annual report as dependent variable.

### 5.3.2 Independent Variables

There are several factors that maybe influence the volume of RP transactions. Motivated by the study of Hu and Li (2010), we would like to classify independent variables into three categories comprising ownership structure variables, control variables and other variables.

We select firm size, leverage, property of holdings and industry in annual report as control variables. Among these variables, firm size is measured by total assets. Leverage is measured by the ratio of debt over asset. Property of holdings is treated as dummy variable and code 1 represents state-owned while code 0 represents non-state-owned. Since there are 30 sectors data collected by us in DataStream, we transform this independent variable into 30 dummy variables.

Other types of variables have not been decided yet. We will continue the research later.

---

**Part VI. Analysis and discussion**

**Part VII. Conclusion**
Reference


Coase, R. H., (1937), The firm, the market and the law, University of Chicago Press.


Dyer, Geoff and Braithwaite, Tom, (2009), US tire duties spark China clash, *Financial Times*


Fortune. (2010). Global 500, Annual ranking of the world’s largest corporations.


Gao SQ, (1996), New Progress in China’s Special Economic Zones, Foreign Languages Press


Jian M. and Wong T. J., (2003), Earnings Management and Tunneling through RP Transactions: Evidence from Chinese Corporate Groups, Department of Accounting, School of Business and Management, The Hong Kong. University of Science and Technology, Clear Water Bay, Hong Kong


Kaboub Fadhel, (2008), positivist paradigm, Leong (Encyc)-Vol -2 (Pat 2)-45523.qxd 1/2/2008 8:38 PM Page 343


Liu, Qiao and Joe Lu, (2004), Earnings Management to Tunnel: Evidence from China’s Listed Companies, working paper.


Perry, Elisabeth J. (Editor) and Wong, Christine (Editor), (1985), Political Economy of Reform in Post-Mao China, *Harvard University Press*


Yu,Verna.(2010). Shenzhen speeches show divide on political reform”. *South China Morning*