

# The Effect of Related Party Transactions through Opportunistic Behaviour Management to Increase Firm Value

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## ABSTRACT

**Objective** – This research aims to determine and analyze related party transactions to increase firm value through opportunistic behaviour management by conducting earnings management on manufacturing companies listed on the Indonesian Stock Exchange between 2015 and 2018.

**Methodology/Technique** – There are 34 companies that fulfill the requirements to become the sample of this study. The method applied in analyzing the data is verification using path analysis.

**Findings** – The results of the research show that related party transactions do not have any significant effect on firm value however it indicates a positive impact. Moreover, related party transactions do not have any significant impact on earning management yet it gives a negative impact on earning management.

**Novelty** – The influence of earnings management shows a positive impact on firm value while it shows no signs of positive impact on firm value. The analysis shows that the value of the indirect impact of related party transactions through earnings management towards firm value is negative being 0.022 smaller than the direct impact of related party transaction toward firm value which is 0.053. This indicates that related party transactions through earnings management have no significant impact on firm value.

**Type of Paper:** Empirical.

**Keywords:** Related Party Transactions; Earnings Management; Firm Value.

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## 1. Introduction

Company performance is measured by its ability to generate profits and is one of the determining factors for management, investors, or potential investors in making investment decisions.

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Therefore, a company will strive to improve its performance by generating high profits. Large profits generated by companies are more attractive to investors compared to companies with low profits. Facing intense competition, companies must make various efforts to generate large profits to increase the firm's value. One of the ways that can be achieved is by expanding its business by opening a new factory or establishing a subsidiary. If there is a transaction between the holding company and the subsidiary, this is called a related party transaction or a related transaction.

Related party transactions can increase the company's operational efficiency, but they can also be detrimental (Ken et. al. 2010). Companies can use related party transactions to optimize the allocation of internal resources, to improve the companies' competitiveness. In addition, if the company conducts a transaction with outside parties, it also can reduce risks, transaction costs and transaction time, tax expenditures and others, (Chen et. al. 2009). According to Kohlbeck and Mayhew (2010) in Utama (2015), special relationship transactions can be categorized as abusive related party transaction based on the conflict of interest hypothesis or efficient related party transactions based on the efficient transaction hypothesis.

Related party transactions in the category of efficient related party transactions are more profitable for shareholders because they can improve the efficiency of the company in general. This is due to the fact that the transaction is considered economically rational with low transaction costs borne by the company. In addition, the transaction is carried out between parties in the same control so that the contractual costs can be lowered and the negotiation process can be carried out faster than non-related party transactions. Related party transactions can be measured by the amount of related party transactions disclosed in a company's financial statements. A financial report contains financial information for interested parties that can be a positive or negative signal to the company. A company wants its financial statements presented to provide a signal to investors that it is in a good condition.

Management will try to report high profits because this indicates that the company is in good condition. There are many ways for management to describe the condition of the company in order to increase the value of the company by escalating profits obtained. This is what encourages management to behave opportunistically by conducting earnings management. Earnings management can be achieved through transactions among parties that have special relationships, in this case, the relationship between the holding company and subsidiary company (Mckay, 2002).

A transaction with a special relationship can result in the transfer of profits from the subsidiary company to the holding company (Cheung et. al. 2006). Geriesh (2003) states that the greater the number of transactions with special parties, the greater the tendency for accounting fraud. A transaction with a party that has a special relationships shows a tendency for opportunist management. This is evidenced by the finding of high levels of sales with special relationship transactions, particularly for control shareholders and other companies within the group, when companies have incentives to manipulate profits. A transaction with special relationships is mostly carried out by companies in the group compared to companies operating independently (Jian & Wong, 2003). The results of research by Nekhili, M., & Cherif, M. (2011). regarding the transaction relationship of parties that have related parties with the practice of earnings management shows that the relationship between parties with special relationships has a significant and positive effect on earnings management. Meanwhile, the results of Arie Pratama (2018) show that Utilization of RPt and Tax Avoidance by Companies increases Firm Value. This is in contrast with the results of Suryantina (2013) who states that the debt of related party transactions does not have a significant and negative effect on earnings management. Research by Gordon, Henry and Palia shows that industry adjusted returns are negatively associated with related Party Transactions whilst the results of Manaligod (2012) show that there is no relationship among RPTs (Disclosure Compliance Index and Auditor Type) and Firm Size.

Based on the explanation above, the issues to be addressed in this study are: (1) What is the effect of special relationship transactions on firm value and earning management, and (2) How does earnings management influence firm value and what is the impact of special relationship transactions through earnings management on firm value.

This research is expected to provide information and empirical evidence for companies, management, investors and prospective investors about opportunistic behaviour management in order to increase firm value with special relationship transactions, and to add to existing financial accounting literature.

## **2. Literature Review**

### **2.1 Agency Theory**

Agency theory classifies accrual earnings management motivation into two categories, namely: opportunistic and signaling. Opportunistic management motivation conducts accounting policies that aggressively report figures that are higher than actual profits whilst signaling management motivation presents financial information that is expected to signal prosperity to shareholders (Chava, 2008). The signals can be in the form of promotions or other information that states that the company is better than other companies (Machfoedz, 1999 in Yasa, 2010).

### **2.2 Special Relationship Transactions**

According to the International Financial Statement (IFRS) in IAS 24.9, a transaction of a special relationships is between people or entities that are related to the entity preparing their financial statements (referred to as 'reporters'). Hence, related party transactions involve the transfer of resources, services, or obligations between related parties, regardless of whether prices change or not. A transaction with parties that have a special relationship in the company's operational activities, including sales, purchases, debt, accounts receivable, loans both short-term loans and long-term loans. Jian and Wong (2003) state that the debt obligations of a special relationship can arise due to a sale or purchase transaction. Debt and receivable transactions have an influence on financial statements, particularly when calculating the accounting profits of a company. Special relationship debt is used to determine how much the company is involved in debt from a special relationship.

### **2.3 Earnings Management**

Earnings management is a way of presenting profits that aims to maximize management utility or increase market value through the selection of a set of accounting procedures by management (Scott, 2006). There are two perspectives in understanding earnings management by company managers. First, aiming for opportunistic behavior and second, aiming for efficient contracting. Earnings management is interesting in terms of the ability to identify opportunistic behavior of management, namely the possibility of certain motivations that encourage them to regulate financial data reported in a certain period. Earnings management can be interpreted as a management action that affects reported earnings and gives incorrect economic benefits to the company (Merchant & Rockness, 1994). There are two techniques for measuring earnings management, namely accrual earning management and real earnings management. The most widely used approach in testing accrual earnings management is the model developed by Jones (Jones, 1991).

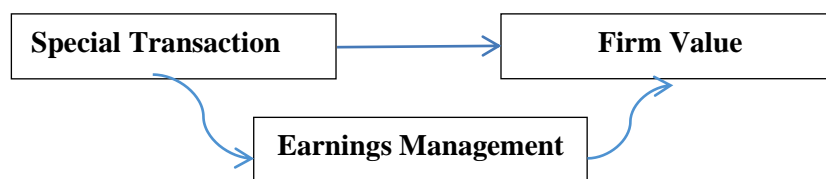
### **2.4 Firm Value**

Firm value reflects the market valuation of investment funding and asset management decisions and is often calculated based on book value and stock market value (Keown et. al. 2005). A firm's value can be measured using Tobin's Q (known as the Q ratio) which describes a company's investment opportunity (Lang et. al. 1998) or the company's growth potential (Tobin & Brainard, 1968); Tobin 1969). The Tobins Q value is generated from the total of the stock market value (market value of all outstanding) with the book

value of liabilities compared to the equality book value. Hence, the Tobins' Q can be used to measure financial performance in terms of potential market value which is directed at investment growth potential. Companies that have a large Q ratio typically have strong competitive advantages.

## 2.5 Theoretical Framework

A transaction with related parties is indicative of management opportunistic tendencies. A transaction with special relationships is typically carried out by companies in the group compared to companies operating independently. Transactions with special relationships cause the transfer of profits from the subsidiary company to the holding company (Cheung et. al. 2006). Geriesh (2003) shows that the greater number of transactions with parties that have a special relationship, the greater the tendency for accounting fraud. Based on the description and the literature review, the related variables in this study can be formulated through the following framework:



Picture 1. Framework Chart

## 2.6 Hypothesis

### 2.6.1. The Effect of Related Party Transactions on Firm Value

Credit purchase transactions from a special party will create a business debt account in the company's financial statements. When a purchase to a related party is made, the purchase price can be arranged in accordance with the interests of these parties. When a company determines to use a lower purchase price, the debt held by the company also decreases and the cost of goods sold is lower, followed by increased profits. Huang and Lu (2010) state that there is a significant and positive relationship between the debt of the parties with a special relationship to the company's performance as measured by the Tobins' Q. This shows that the existence of a debt made to special parties will increase the value of the company. Based on this description, the first hypothesis of the research is as follows:

H1: Related Party transactions have a positive effect on firm value.

### 2.6.2. The Effect of Related Party Transactions on Earnings Management

Through special profit transactions, a company can be manipulated so that it improves steadily. Earnings management is usually done to increase or decrease company profits on its financial statements. The efficient transaction hypothesis theory explains that privileged transactions are profitable because these transactions are considered economically rational with low transaction costs borne by the company. With low transaction costs, it is profitable for the company and will increase earnings income. The increase in earnings income will reduce the company's earnings management actions. The results of research by Suryantina (2013) found that RPT has no significant effect and was negative towards earnings management actions. Based on the description above, the second hypothesis can be formulated as follows:

H2: Related party transactions have a negative effect on earnings management.

### 2.6.3. The Effect of Earnings Management on Firm Value

Earnings management occurs when company management uses their discretion in financial reporting and transaction management either to outwit outsiders about fundamental economic performance or to influence decision-makers who depend on the reported numbers (Healy & Wahlen 1999). There are various reasons why management conducts earnings management such as to influence the perception of capital markets, to increase management compensation, to reduce the tendency to violate loan agreements, borrow and to avoid regulatory intervention (Gordon, 2007). Management tends to report high profits for certain purposes. High profit can be a leading indicator in the success of management. When profits are reported as being greater than operating cash flow, this can increase the value of the company (Sloan in Herawaty, 2008). Therefore, management will report profits adjusted to its purpose, namely to increase the value of the company. Based on the description above, the third hypothesis can be formulated as follows:

H3: Earnings Management has a significant effect on firm value.

### 2.6.4 The Effect of Related Party Transactions on Firm Value through Earnings Management

There are many ways for management to describe a positive firm value which is indicated by the high profits earned, to promote the condition of the company as being better than it actually is. A transaction involving special relationships has the potential to influence the company's financial statements as a basis for evaluating the company's financial performance. Special relationship transactions are identified with earnings management practices for opportunistic goals. It is possible for the company to conduct earnings management through special relationship transactions so that the firm's value is considered good. Based on the description above, the fourth hypothesis in this study is as follows:

H4: Earnings management is a variable intervening related party transaction on firm value.

## 3. Research Methodology

This study uses secondary data. The research method is explanatory research (Cooper, 2008). The analytical model used is path analysis. The data is analyzed by testing classical assumptions, namely the normality test, the multicollinearity test, the autocorrelation test and the heteroscedasticity test. While testing the hypotheses F-test and t-test, hypothesis testing is done using the criteria of the (Hair et. al., 2010), as follows:

1. If the value of t statistic  $\geq 1.96$  with  $\alpha = 5\%$ , then  $H_0$  is rejected and  $H_1$  is accepted.
2. If the value is statistically  $< 1.96$  with  $\alpha = 5\%$ , then  $H_0$  is accepted and  $H_1$  is rejected.

### 3.1 Objects of the Research

The object of this research is limited to related party transactions, earnings management and firm value in manufacturing companies listed on the Indonesian Stock Exchange (IDX) that publish auditors' annual financial statements from 2015-2018. The sample was selected using purposive sampling with selected criteria as many as 34 manufacturing companies.

### 3.2 Operational Variables

#### 1. Related Party Transactions

Related party transactions are measured using the method developed by Jian and Wong (2013) as follows:

$$\text{Debt RPT} = \frac{\text{Total Debt Transaction from the Parties}}{\text{Total Liability Owned by the Company}}$$

#### 2. Earnings Management

Earnings management is measured by the value of discretionary accrual (DA) using the *Modified Jones Mode* as follows:

$$DA_{it} = (TA_{it}/A_{it-1}) - NDA_{it}$$

Notation:

$DA_{it}$  = Company's discretionary accruals  $i$  in period  $t$ ,  $NDA_{it}$  = Company's nondiscretionary accruals  $i$  in period  $t$ ,  $TA_{it}$  = Total company's accrual  $i$  in period  $t$ .

#### 3. Firm Value

Firm value is measured using the Tobin's  $Q$  with the following formulation:

$$\text{Tobin's } Q = \frac{\text{Equity market value} + \text{Debt}}{\text{Book value of equity} + \text{Debt}}$$

#### 4. Results

The classic assumption test aims to determine whether the regression obtained can produce good and unbiased linear estimates. Based on the classic assumption test, the data is normally distributed, there is no multicollinearity, it does not contain heteroscedasticity and there is no autocorrelation. It can be said that the regression model is feasible to predict the value of earnings management and firm value. From Table 1 below, it can be seen that related party transactions have a positive effect on firm value (0.075). This means that each increase in party transactions will increase the value of 0.075. Moreover, the results also show that relevant party transactions have a negative effect on earnings management (0.183). Based on Table 1 below, earnings management has a positive effect on firm value (0.120), which means that every increase in earnings management by 1 unit will increase the value of the company by 0.120.

#### 5. Discussion

##### 5.1 The Effect of Related Party Transactions on Firm Value

This research proves at the level of  $\alpha = 5\%$  with a statistical value of 0.743 ( $0.743 < 1.96$ ) which means that related party transaction have no significant effect on firm value. However, this research shows that the direction of related party transactions on firm value is positive. This shows that the existence of debt made to related parties will increase firm value.

Table 1. Coefficients<sup>a</sup>

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	2.776	0.633		4.386	0.000		
1 REL_PARTY	1.751	2.355	<b>0.075</b>	0.743	<b>0.459</b>	0.966	1.035
MEA	0.575	0.485	<b>0.120</b>	1.186	<b>0.239</b>	0.966	1.035

Dependent Variable: TOBIN' s Q

The magnitude of the contribution of exogenous variables in related party transactions and earnings management to firm value is indicated by the R-Square Value in table 2 which is 1.7% while the remaining 98.3% is the result of other variables that are not explained in this research.

Table 2. Model Summary<sup>b</sup>

Model	R	R Square	Adjusted R Square	Std. An error of the Estimate	Durbin-Watson
1	0.130a	<b>0.017</b>	-0.003	4.4544832	0.616

Predictors: (Constant), MEA, REL\_PARTY

Dependent Variable: TOBINSQ

## 5.2 The Effect of Related Party Transactions on Earnings Management

This research proves at the level of  $\alpha = 5\%$  with statistical value of -1.864 ( $-1.864 < 1.96$ ) that related party transactions have no significant effect on earnings management. The variable contribution of related party transactions to earnings management which is seen from the R-Square value is 0.034 or 3.4% while the remaining 96.6% is the result of other variables which are not explained in this study. The path coefficient and coefficient of determination can be seen in Table 3 below:

Table 3. Path Coefficient and Determination Coefficient

Model	Path Coefficient	T	sig	R2
<b>X (PXY)</b>	-0.183	-1.864	0.065	0.034

## 5.3 The Effect of Earnings Management on Firm Value

This research proves at the level of  $\alpha = 5\%$  with statistical value of 1.186 ( $1.186 < 1.96$ ) that earnings management does not have a significant effect on firm size. This study shows that the direction of the influence of earnings management on firm size is positive. This means that management tend to report high earnings for certain purposes. High profit can be a leading indicator in the success of management in managing the company. However, based on the hypothesis test, the effect of earnings management on firm value is not significant.

## 5.4 The Effect of Related Party Transactions through Earnings Management on Firm Value

Based on the test results as shown in Table 4, the direct effect of related party transactions on firm value is 0.075, and the magnitude of the indirect influence of related party transactions through earnings management

is negative 0.022 meaning that the total effect of related party transactions through earnings management on firm value is 0.053. These results indicate the magnitude of the indirect effect is smaller than the direct effect ( $-0.022 < 0.075$ ) which means that related party transactions through earnings management have no significant effect on firm value.

Table 4. The Effect of Related Party Transactions Through Earnings Management on Firm Value

Model	Direct Influence	Indirect Effects	Total Influence	Sig	Result
RPT through MEA to NP	0.075	$-0.183 \times 0.120$ = -0.022	$0.075 - 0.022$ = 0.053	Indirect influence Direct influence	Not significant

Source: Secondary Data Processed with SPSS V.22 (2017)

## 6. Conclusions and Suggestions

### 6.1 Conclusions

This research shows that the direction of related party transactions on firm value is positive, which means that debt made to related parties will increase firm value. Related party transactions have a negative effect on earnings management (0.183). Related party transactions have no significant effect on earnings management but they do have a negative direction which means that related party transactions are beneficial to management because the transaction is considered economically rational with the low transaction costs borne by the company. The magnitude of the effect of earnings management on firm value is 0.120. This indicates that the direction of the influence of earnings management on firm value is positive which means that management tends to report high earnings for certain purposes. The magnitude of the direct effect of related party transactions on firm value is 0.075, and the amount of indirect influence is negative 0.022, so that the total effect of related party transactions through earnings management on firm value is 0.053. The amount of indirect effect is smaller than the direct effect. Thus, it can be concluded that related party transactions through earnings management have no significant effect on firm value.

### 6.2 Suggestions

This research has several limitations that might cause a disruption to the results of research. Future research should use samples from all companies and to adopt a longer observation period. Furthermore, it is necessary to consider all proxies from related party transactions, earnings management, and firm value to increase the results of the hypothesis. Related party transactions, earnings management, and firm value can be influenced by other external factors that have not been studied in this research so that the results of the study do not cover the whole area.

### 6.3 Managerial Implications

The results of this research provide insight to companies and investors on the influence of special relationships to firm value. Furthermore, the results are expected to be useful for investors for their investment decision making process, in which transactions with parties that have special relationship to a company can be indicative of opportunistic management behavior.



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