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Silence is golden? Evidence from disclosing related-party transactions in China ☆

Agnes W.Y. Lo [a], Raymond M.K. Wong [b,*]

[a] Department of Accountancy, Lingnan University, Hong Kong
[b] Department of Accountancy, City University of Hong Kong, Hong Kong

A B S T R A C T

The significance and the manipulative nature of related-party transactions (RPTs) render transparent disclosure necessary and relevant for investors who infer firm value from accounting disclosures. However, the full disclosure of RPTs may not be cost effective because not all of the information that firms possess is value relevant to financial statement users. This study provides new evidence on the value relevance of additional disclosure on RPTs by using a unique, mandatory disclosure requirement of transfer pricing policies in China. We hypothesize and find that, compared to the mere disclosure of amounts for related-party sales, the disclosure of transfer pricing methods provides incremental value-relevant information beyond total sales. We also show that the disclosure of transfer pricing details complements weak corporate governance mechanisms and improves the prediction of abnormal returns. Our findings are robust to various model specifications, and demonstrate the significance of transparent and relevant RPT disclosure in inferring firm value.

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* Corresponding author at: Department of Accountancy, City University of Hong Kong, Kowloon Tong, Hong Kong. Tel.: +852 3442 8544; fax: +852 3442 0349.

E-mail address: ac.raymond@cityu.edu.hk (R.M.K. Wong).

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1. Introduction

Related-party transactions (RPTs) are commonly perceived as profit-shifting tools among group-affiliated companies to reduce taxes, prop up earnings, and tunnel profits[1] (Aharony et al., 2010; Gramlich et al., 2004; Harris, 1993; Jacob, 1996; Jian and Wong, 2010). To tackle these tax avoidance activities, tax authorities in some countries impose strict documentation requirements and request companies to provide detailed information during tax audits such as organizational structure, details of the transfer pricing methods used, and descriptions of analysis in developing the transfer pricing methods (Ernst & Young, 2013). Although RPTs are also commonly used for achieving various financial reporting purposes, such as earnings management and fund transfer within a corporate group, investors are not able to request of these companies' additional information beyond the statutory requirements. They mainly rely on the mandatory RPT disclosure reported in the financial statements to assess the presence and extent of manipulative RPTs. Whether such disclosure of RPTs for financial reporting purposes provides relevant information is thus an important issue for investors, researchers, and regulators to properly assess firm performance and infer firm value.

This study investigates whether disclosures of RPTs provide incremental value-relevant information beyond comprehensive income. RPT disclosure is a significant yet under-researched accounting issue. Prior studies evaluate the value relevance and incremental information content of accounting data by comparing the association between stock returns and accounting figures reported in financial statements. These figures include foreign translation adjustment, depreciation, fair value assets, and other comprehensive income (Brown and Sivakumar, 2003; Jones and Smith, 2011; Kang and Zhao, 2010; Louis, 2003; Song et al., 2010). However, still unresolved is the relevance of RPT disclosures in determining firm value beyond traditional financial statement items (OECD, 2012). This paper aims to shed light on this issue and extends prior literature by investigating whether the disclosure of transfer pricing details complements weak corporate governance mechanisms and improves the prediction of abnormal returns.

RPTs are substantial in both Western and Asian countries. Although RPTs are a legitimate and common business practice worldwide that may improve the performance of affiliated companies (Gordon et al., 2007; Khanna and Palepu, 2000), investors and other stakeholders are increasingly concerned with the possible abuse of RPTs (Gordon et al., 2007; OECD, 2009). Under certain conditions, RPTs can facilitate the personal gain of management and controlling owners or the tunneling of profits away from minority shareholders of a listed firm (OECD, 2009). Therefore, RPTs should be properly disclosed in financial statements to alert investors of the risk of fraudulent reporting and profit expropriation.

Investors are expected to be protected from expropriation to a certain extent if equity value already reflects a discount for such expropriation (Cheung et al., 2006; Kohlbeck and Mayhew, 2010). However, market participants are unsure that the existing RPT disclosure can achieve real transparency for identifying RPT manipulation (OECD, 2012). Even if the accounting standards promote proper RPT disclosure, this information may not be presented in a clear and investor-friendly manner (European Commission, 2011). The global accounting scandals involving Enron, Adelphia, and Tyco support this assertion. Investors experience difficulty in understanding the real motivation for RPTs from the financial statements and are unable to make investment decisions accordingly.

While Ryngaert and Thomas (2012) find that historical information concerning related-party relations helps to detect tunneling via RPTs, collecting this historical data is time-consuming, if not impossible, for general investors. Therefore, investors are likely to rely on the mandatory disclosure of RPTs reported in the current financial statements. The substance of the information contained in these disclosures is a significant issue for investors and market participants, and RPT disclosures deserve thorough research and investigation. A study of the value relevance of RPTs can extend our knowledge of the relevance and reliability of RPT disclosures with respect to equity value (Barth et al., 2001).

[1] The term "tunneling" or "tunnel" was originally used to describe "the expropriation of minority shareholders in the Czech Republic (as in moving assets through an underground tunnel)" (Johnson et al., 2000). Lo et al. (2010a) find that Chinese listed companies tunnel profits to parent companies via the manipulation of transfer prices of related-party sales transactions. Other tunneling activities can include loan guarantees and the manipulation of dividend payout rates.

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