

Related Party Transactions and Earnings Quality: Does Corporate Governance Matter?

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ABSTRACT

This paper investigates the relationship between related party transactions (RPTs) and earnings quality (EQ). In addition, this paper examines whether there is a positive moderating effect of corporate governance (CG) on the relationship between RPTs and EQ. This study uses seven moderating variables to measure CG mechanisms and suggests that the effect of RPTs on EQ is conditional on CG mechanisms. Based on 294 firm-year samples for 2011–2012, this study finds evidence that the existence of RPTs represents a potential conflict of interest, which provides greater incentives to controlling shareholders to expropriate minority shareholders thus managing earnings to mask up such expropriations. However, the negative effect is mitigated with the presence of good governance, namely, the level of board independence and audit quality.

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INTRODUCTION

The quality of earnings reported in financial statements is the most important characteristic to improve capital market efficiency (Ewert & Wagenhofer, 2010). However, there is no formal standard that defines earnings quality as the assessment of earnings quality is subject to many factors. Dechow and Schrand (2004) suggest earnings quality as a measure that defines how well the reported earnings can reflect the actual firm performance. Although there is no clear definition, the standard setters such as the Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) provide the common framework on a number of qualitative characteristics that should achieve a high-quality financial report such as relevance, faithful representation, comparability, verifiability, timeliness, and understandability (Ewert & Wagenhofer, 2010). Thus, when earnings are managed and do not portray these qualitative characteristics, the quality and credibility of the reported earnings are questionable.

In firms with weak corporate governance (CG), controlling shareholders can expropriate minority shareholders in many ways. One of them is through related party transactions (RPTs). Prior studies found evidence concerning the relationship between poor governance and poor quality of financial reporting, including earnings manipulation, financial restatements and fraud (see Dechow, Sloan, & Sweeney, 1996; Beasley, 1996; Peasnell, Pope, & Young, 2000; and Tan, Ong, Chong and Samuel, 2016). Several studies found that Malaysia has characteristics that might indicate a high level of RPTs and earnings management: for instance, high family ownership and weak institutional structure (Claessens, Djankov, & Lang, 2000). Although RPTs provide many advantages to the firm, such as acquiring and disposing of substantial assets among the related parties (Mustafa, Abdul Latif, & Taliyang, 2011), better coordination of activities and feedback between contracting parties, and mitigation of holdup problems in the contracting process (Ryngaerts & Thomas, 2007), most of the transactions are actually abusive and detrimental to shareholders. For example, the corporate scandal and collapse of Enron provide evidence in which some of the losses sustained by shareholders were the direct result of RPTs (Thomas, 2002). And, with the concentrated ownership in Malaysian firm, the existence of family relationship among related parties facilitates RPTs (Munir *et al.*, 2013). In addition, a weak institutional structure and the dominant presence of a concentrated ownership in Malaysian firms also enable management to expropriate minority shareholders (Claessens *et al.*, 2000).

According to Malaysian Financial Reporting Standard (MFRS) 124: Related Party Disclosures,¹ RPTs are the transfer of resources, services, or obligations between a reporting entity and a related party, regardless of whether a price is charged. Gordon, Henry, Louwers, and Reed (2007) defined RPTs as transactions between a company and related entities (i.e., subsidiaries, affiliates, principal owners, officers, and directors). Prior studies argued two different perspectives of RPTs, each with a different implication for earnings quality (EQ). The first view is that of the conflict of interest (Gordon, Henry, and Palia, 2004) and the second view concerns efficient transactions (Gordon *et al.*, 2004). The conflict of interest view

¹ MFRS 124: Related Party Disclosures is issued by the Malaysian Accounting Standard Board (MASB) in November, 2011. The standard is applicable beginning on/after January 1, 2012. It is equivalent to International Accounting Standard (IAS) 24: Related Party Disclosures issued by the IASB. Available at: <http://www.masb.org.my/pdf.php?pdf=MFRS%20124%20042015.pdf>

suggests that such transactions are harmful and unfavorable to the shareholders. This view is consistent with agency issues of the type considered by Berle and Means (1932), and Jensen and Meckling (1976), which portray RPTs as an agency conflict between the management and shareholders. Board members or officers have the incentive to manage earnings for their private gain (i.e., increase perquisites), or possibly to conceal such expropriation (Gordon & Henry, 2005). The second view claims that RPTs are efficient transactions that rationally fulfill the economic demands of a firm. This view extends the concept of transaction costs developed by Coase (1937) and Williamson (1975), which maintains that RPTs do not harm and, perhaps, even benefit shareholders (see Stein, 1997; Khanna & Palepu, 2000; Chang & Hong, 2000). For instance, RPTs rationally fulfill company demands, such as the need for in-depth company knowledge and expertise or providing alternative forms of compensation.

Prior evidence regarding RPTs is scarce in this field of research, especially in Malaysia, and, specifically, in the context of the quality of reported earnings by Malaysian firms. The available evidence of RPTs in Malaysia has been contributed by Munir and Mohd Salleh (2009) and Abdul Wahab, Haron, Yahya, and Lok (2011). Research concerning the effect of RPTs and earnings management has been confined to the United States (U.S.) (Gordon & Henry, 2005), Hong Kong (Cheung, Jing, Rau & Stouraitis, 2009), and China (Wong & Jian, 2003; Aharony, Wang, & Yuan, 2005). The present study attempts to examine the relationship between RPTs and EQ in Malaysia where the corporate structure, nature of capital market (relationship based economy)² and ownership structure (high family ownership) are conducive to RPT activities. The study by Munir and Mohd Salleh (2009) analyzed the relationship between family ownership and EQ with the presence of RPTs using a small sample in 2004. Subsequently, the study by Abdul Wahab *et al.* (2011) further extended the previous evidence of Munir and Mohd Salleh (2009) by using a larger sample for 2005–2007 and discussed the relationship between RPTs and firm performance proxies by return on assets (ROA). However, the main difference between these two studies was the source of data for the RPTs. Abdul Wahab *et al.* (2011) used circulars sent to the shareholders as their main source of data, which is consistent with extant literature, while Munir and Mohd Salleh (2009) utilized the annual reports. This study intends to extend the work done by Munir and Mohd Salleh (2009) and Abdul Wahab *et al.* (2011) by examining the effects of RPTs on EQ in Malaysian firms. However, this study differs in terms of the latest available evidence, which is utilizing data from 2011–2012, and follows the approach used by Abdul Wahab *et al.* (2011) by referring to circulars distributed to shareholders as the main source.

Furthermore, to ascertain the potential effectiveness of CG in protecting minority shareholders from controlling shareholders through RPTs, this study examines whether internal and external CG moderates the relationship between RPTs and EQ. The study explores two research questions: (1) Are RPTs associated with EQ in Malaysian firms? (2) Does the existence of good CG affect the relationship between RPTs and EQ? To answer these questions, a sample of 294 firm years, which issued circulars to shareholders for the period 2011 and 2012, are collected. The study examines the direct relationship between RPTs and EQ. In addition, the

² According to Hung, Wong and Zhang (2011), the characteristics of emerging markets are based on the relationship-based economies in which the markets are less developed, and firms rely heavily on their owners' and senior executives' social and political networks to conduct business and engage heavily in relationship-based transactions.

study also tests the moderating effects of CG variables, namely, chief executive officer (CEO) duality, board independence, board size, multiple directorships, institutional ownership, and audit quality on relationship between RPTs and EQ.

The study finds that firms with RPTs are more likely to report lower-quality earnings. The study also finds that CG mechanisms weaken the negative effects of RPTs on EQ. As expected, the results show that the level of independence and audit quality helps in monitoring and reducing earnings manipulation activities by the firm. However, the study finds no significant evidence that CEO duality, board size, multiple directorships, family ownership, and institutional ownership moderate the relationship between RPTs and EQ.

REVIEW OF LITERATURE

Institutional Background

The Malaysian capital market is affected by the relationship-based economy. This results from corporate ownership in Malaysia being highly concentrated, which is consistent with the findings by LaPorta, Lopez De Silanes, and Shleifer (1999). According to Claessens *et al.* (2000), the majority of shareholdings in Malaysian firms are owned by families with the owners of the firm sitting on the board of directors. In addition, Claessens *et al.* (2000) noted that the founder family and descendants have strong control of the firm. Furthermore, a survey undertaken by Claessens *et al.* (2000) on East Asian corporations found that of the 238 Malaysian companies in the sample, 10.3% were widely held, 67.2% were family owned companies, 13.4% were owned by the government, while financial and nonfinancial institutions owned 2.3% and 6.7%, respectively. The World Bank (1999) reported that about 85% of firms in Malaysia had owner-managers. According to the study by the World Bank, the post of CEO, chairman of the board or vice chairman belong to a member of the controlling family or a nominee. These studies show that family-owned and controlled companies are common in the Malaysian business environment.

The Bursa Malaysia Listing Requirements (BMLR) provide a comprehensive definition of RPTs in Section 10.02 and identifies two types of RPTs: related party transaction (RPT) and recurrent related party transaction (RRPT). The RPT is defined as a transaction entered into by the listed issuer or its subsidiaries, which involves the interest, direct or indirect, of a related party (BMLR, Part E, Section 10.02, para k). Meanwhile, the RRPT means that an RPT, which is recurrent of revenue or of a trading nature, which is necessary for the day-to-day operations of a listed issuer or its subsidiaries (BMLR, Part E, Section 10.02 para j). In addition, Section 10.08, Part E in Chapter 10 BMLR requires firms to make an immediate announcement to the exchange of RPTs and provide relevant information. A circular needs to be sent to the shareholders to obtain their approval at the extraordinary general meeting if the RPTs of the firm exceed 5% of any of the percentage ratios (Chapter 10, Section 10.08, para 2). Furthermore, if the percentage ratio exceeds 25%, independent and principal advisors must be appointed by the firm to verify and ensure that the transactions are fair and reasonable to all the shareholders (Chapter 10, Section 10.08, para 4). The BMLR also states that firms

only have to make an announcement of a RRPT when the consideration is RM one million or more, or if one of the percentage ratios is 1% or more (Chapter 10, Section 10.09, para 1).

Good CG is important in order to ensure the fair treatment and protection of rights for all shareholders, particularly for protecting the rights of the minority shareholders. Malaysia has undertaken initiatives concerning CG, especially after the Asian Financial Crisis in 1997–1998, which exposed a number of poor CG practices. The capital market in Malaysia experienced two events in 2001 relating to CG reform. The first was the introduction of the Malaysian Code on Corporate Governance (MCCG)³ as part of the Kuala Lumpur Stock Exchange (KLSE) Listing Rules. The MCCG is the cornerstone of the reform agenda on CG in Malaysia, which provides guidelines on the principles and best practices in CG. In addition, the MCCG provides direction for the implementation of better CG and charts the future prospects of CG in Malaysia. According to Abdul Wahab, How, and Verhoen (2007), the introduction of the CG Code has proven to be successful in improving the practice of CG among Malaysian listed firms. The second event was the establishment of the Minority Shareholder Watchdog Group (MSWG). The MSWG was founded in July 2001 by five major institutional shareholders in Malaysia: Permodalan Nasional Berhad (PNB), Lembaga Urusan Tabung Haji (LUTH), Employees Provident Fund (EPF), Lembaga Tabung Angkatan Tentera (LTAT), and the Social Security Organisation (SOCSO). The MSWG plays several important roles in the Malaysian capital market: it promotes shareholder activism; monitors for breaches and non-compliance in CG practices by public listed companies (PLCs); keeps the stakeholders updated concerning the current CG practices; and conducts education programs for the public, particularly the retail investors, to inform them of their rights as shareholders and as investors. Although, to date, there is no substantial evidence to show that the MSWG has effectively helped in protecting minority shareholders, it can be argued that its introduction could stimulate the monitoring role of the institutional investors, especially the CG structures of the firms.

HYPOTHESES DEVELOPMENT

Related Party Transactions

Normally, RPTs are portrayed as potential conflicts of interests. However, prior studies suggest two alternative views of RPTs. The first view is conflict of interest (Gordon *et al.*, 2004). This is consistent with the type of agency issue considered by Berle and Means (1932) and Jensen and Meckling (1976) who portray RPTs as an agency conflict between the management and the shareholders, inasmuch as the manager has a greater incentive to expropriate the firm's resources for their private gain. In the similar vein, Kuan, Tower, Rusmin, and Mitchell Van der Zahn (2010) posit that there is no statistical significant evidence to show that RPTs lead to higher earnings management in Indonesian firms. In addition, as implied by the media and standard setters, RPTs represent the potential expropriation of the firm's resources (Gordon & Henry, 2005). Board members or officers have a greater incentive to manage earnings when

³ The MCCG was first issued by the Securities Commission of Malaysia in March 2000 and was subsequently revised twice, in 2007 and 2012. The Code was adapted from United Kingdom's Hampel Report. The MCCG 2012 is the latest first major deliverable of the Corporate Governance Blueprint 2011, which was launched by the Securities Commission (SC) in July 2011.

they engage in RPTs to expropriate the firm's resources in order to cover up their expropriation activities. In the context of RPTs and earnings management, Wong and Jian (2003) conducted a study to see whether and how controlling shareholders use RPTs in earnings management and tunneling as well as the market response to such activities in China. They found that the group-controlled firms report an abnormally high level of related party sales when they have the incentive to increase earnings to meet government requirements for new equity offerings or to avoid delisting (Wong & Jian, 2003). Such findings provide direct evidence concerning how a conflict of interest happens when large shareholders expropriate minority shareholders.

An alternative explanation for RPTs is that they are not harmful to shareholders and that they constitute an efficient transaction that rationally fulfills economic demands that bind the party to the company. Gordon and Henry (2005) argued that RPTs could be more effective than engaging a similar transaction with an unrelated party. It may be worthwhile for the company to engage with a related party because it is bound to the company, and there would be less incentive for the company to manage the earnings. Several researchers have focused on the benefits of corporate groups as well as RPTs and firm performance (Khanna & Palepu, 2000; Chang & Hong, 2000). According to Khanna and Palepu (2000), the potential benefits of transactions within business groups include the ability to mitigate external market failure from access to these internal institutions. This benefit arises because it is costly for emerging market firms to acquire the necessary inputs, such as finance, technology, and management talent, due to the absence of intermediary institutions. Similarly, Chang and Hong (2000) conjectured that the internal capital market of business groups supplement an inefficient external market, and the vertical integration within a group enables it to share technological resources as well as reduce transaction costs. Hence, based on the above discussion and consistent with prior studies, this study hypothesizes that:

H1: There is a significant negative relationship between RPTs and EQ.

Corporate Governance

As suggested by Leuz, Nanda, and Wysocky (2003), good CG limits the tunneling activities of the controlling shareholders. If earnings management in Malaysia is indeed primarily induced by tunneling, then this study should observe that firms with good governance tend to have less earnings management and report high EQ. In a different context of study, several researchers reported that, with regard to RPTs and firm performance, good CG practices do matter in aligning the interests of the management and the shareholders (see Gordon *et al.*, 2004; Ryngaert & Thomas, 2007; Chien & Hsu, 2010; Abdul Wahab *et al.*, 2011). Thus, in order to minimize the agency cost resulting from the agency problem, firms need to practice better CG to overcome this potential conflict of interest. Accordingly, this study discusses the role of the CG mechanism in attaining a high quality of earnings. Internal governance consists of CEO duality, board independence, board size, multiple directorships, and family ownership. Meanwhile, external governance consists of institutional ownership and audit quality.

CEO Duality

There are two conflicting views concerning the issue of the separation of powers between the CEO and chairman, which are based on the agency theory and the stewardship theory (Abdullah, 2004; Gul & Leung, 2004; Lin, 2005; Abdul Rahman & Haniffa, 2005). According to Gul and Leung (2004), the advocates of the agency theory argue that the separation role of the CEO and the chairman is important to ensure the effectiveness of monitoring over the board management. This is because when the same person holds two important positions, they are likely to pursue their own interests. Mohd Salleh, Mohd Iskandar and Rahmat (2005) revealed that firms with role duality are engaged in more earnings management than firms that have separated the two roles. Their findings indicated that the Code's recommendation of a separation of roles between the CEO and chairman needs to be strengthened. In a different context of study, Abdul Rahman and Haniffa (2005) reported significant evidence concerning the association between role duality and performance for 88 Malaysian samples from 1996 to 2000. They argued that, even though the incidence of role duality in the context of Malaysia is still relatively low compared with other countries, their study provided evidence that firms with role duality perform poorer than firms with a separation of the roles of the CEO and the chairman.

In contrast, the advocates of the stewardship theory support that role duality enhances the decision-making process. According to Lin (2005), under the stewardship theory, it is believed that CEOs view themselves as stewards of the organization. Therefore, as stewards of their firm, their actions are likely to achieve organizational rather than self-pursuing objectives. Abdoli and Royaei (2012) studied a sample of 165 companies quoted on the Tehran Stock Exchange (TSE) from 2005 to 2010. Their findings revealed that EQ decrease in firms without role duality. In addition, Goodwin and Seow (2002) conducted a survey in Singapore regarding the issue of the separation of power between the CEO and the chairman. The results of the survey showed that the respondents who favored the separation of these roles did not provide strong opinions, and the mean score was only 4.85 out of 7.00. They concluded that the issue of separating the roles of the CEO and chairman was not viewed by Singaporeans as being critical in the CG structure. Despite the conflicting views from prior studies with respect to RPTs, it is hypothesized that:

H2a: There is a significant negative relationship between RPTs and EQ when a firm has CEO duality.

Board Independence

According to Abdullah (2004), there are two conflicting perspectives concerning the effectiveness of a board of directors: the agency theory and the managerial hegemony theory. The advocates of the agency theory believe that the presence of a majority of outside directors on the board can reduce agency conflict because they provide an effective monitoring tool to the board (Fama & Jensen, 1983). They argue that, in order to develop their reputation as experts in decision control and to promote themselves as quality directors, the outside directors

are more efficient in monitoring top management and ensuring collusion avoidance with managers to expropriate the wealth of the stakeholders. According to Li (1994), the outside directors are, potentially, a powerful governance mechanism to minimize agency costs and protect shareholders' value. This is because, normally, these directors are managers from other prestigious organizations who possess the expertise, knowledge, skills, and independence. In the context of the emerging market, Jaggi, Leung and Gul (2007), and Kao and Chen (2004) found evidence that earnings management and the presence of a higher proportion of outside directors in the Taiwan and Hong Kong samples are negatively associated, respectively.

However, the proponents of the managerial hegemony theory argue that, when the management is dominated and controlled by the outside directors, the capability of the board of directors to fulfill their monitoring role is questionable (Abdullah, 2004). This theory asserts that the board of directors are weak and ineffective in providing the monitoring roles. Abdullah (2004) argued that, when the selection process for the directors is dominated and controlled by the CEOs, the outside directors are incapable of providing an independent judgment, and the quality of independent directors is also questionable. Mohd Salleh *et al.* (2005) provided evidence that supports the proponents of the managerial hegemony theory in the Malaysian context. Despite the conflicting views from prior studies, in relation to RPTs, it is hypothesized that:

H2b: There is a significant positive relationship between RPTs and EQ of firms with a higher proportion of independent directors.

Board Size

The board of directors retains ultimate control even though most of the decision-making and control functions are delegated to the top management (Beasley, 1996). Therefore, the board plays an important role in monitoring the quality of earnings reported to the public. Prior studies argued that board size does have an impact on the effectiveness of the monitoring function on management. Jensen (1993) argued that smaller boards can work more effectively in providing solutions to the business problem. The disadvantage of having many board members is that larger boards may be slower in making decisions and are more likely to oppose innovation. In addition, Abdul Rahman and Mohamed Ali (2006) found that larger board size has a positive relationship with earnings management, which suggests that larger board size may cause inefficiency and difficulty in controlling potential conflicts among the board members. Furthermore, Vafeas (2000) supported the findings inasmuch as he argued that earnings reported by firms with smaller boards (with a minimum of five members on the board) are viewed by market participants as being more informative.

However, several studies have documented conflicting findings. Haniffa and Hudaib (2006) argued that the board consists of many members who are better able to provide resources to the company. In addition, Karamanou and Vafeas (2005) claimed that larger boards are associated with better updates of management earnings forecasts. Chtourou, Bedard, and Courteau (2001) provided evidence that firms having larger boards are associated with less earnings management. Thus, contrary to the prior findings that indicate that larger boards are associated with earnings

management activity, the evidence provided by Chtourou *et al.* (2001) revealed that firms with a larger board size seem to effectively monitor financial statements. Therefore, despite the conflicting arguments, in relation to RPTs, it is hypothesized that:

H2c: There is a significant negative relationship between RPTs and EQ when the firm has a larger board size.

Multiple Directorships

The issue of multiple directorships or cross directorships is another important aspect of CG. Multiple directorships, which refer to the situation in which directors may sit on more than one board, are legally recognized in Malaysia. However, with effect from 2002, the BMLR has restricted the number of directorships that a director may hold to 10 and 15 in public listed and private companies, respectively. According to Fama and Jensen (1983), multiple directorships can signal the quality of the directors. The appointment of an individual to a number of boards might be the result of the superior performance exhibited by a firm on which they serve as a director or as a member of the management. In the United States, a study conducted by Bedard, Chtourou, and Courteau (2004) found a significant relationship between the average number of cross directorships of independent audit committee members and both income-increasing and income-decreasing earnings management. The authors found that firms consisting of board members with a greater number of additional directorships are likely to have lower earnings management activity. Similarly, a study conducted by Mohd Salleh *et al.* (2005) reported a significant and negative association between multiple directorships and earnings management in Malaysian firms. They suggested that multiple directorships serve as an important internal governance mechanism in mitigating earnings management activity. Based on these findings, it is expected that multiple directorships will have a positive association with the quality of reported earnings.

However, Ferris, Jagannathan, and Pritchard (2003) asserted that firms having directors with multiple directorships might result in the board members becoming distracted through being too busy, which may reduce their ability to effectively monitor the management of the firm. Their findings indicated that this notion of director distraction would result in a decrease in the quality of the reported earnings because the effect of multiple directorships will increase the risk of earnings management activities in organizations. Furthermore, as suggested by Morck, Shleifer, and Vishny (1988), when a director sits on many outside boards, it may make him or her so busy that the ability to monitor the management is compromised, thus resulting in less monitoring effectiveness. Other directors will take advantage of the less effective monitoring by engaging in expropriation activities for their own benefit at the expense of the shareholders. Hence, this situation will provide a greater incentive for directors to manage earnings to conceal the true performance of the firm. Therefore, in relation to RPTs, the discussion above leads to the following hypothesis:

H2d: There is a significant negative relationship between RPTs and EQ when firms have directors with multiple directorships.

Family Ownership

Family ownership could affect the demand and supply of quality earnings in one of two competing ways: the entrenchment effect and the alignment effect. On the one hand, it is based on the argument of several researchers that family ownership can provide a competitive advantage (reduce agency costs) through the better alignment of shareholder and managerial interests. Demsetz and Lehn (1985) found evidence that the controlling shareholders have substantial economic incentives to diminish agency conflicts and maximize firm value. According to Claessens and Fan (2002), the role of the family ownership structure is critical to the effectiveness of CG employed by the firms in Asia. There are several reasons that favor family firms as the agent to reduce agency costs. Wang (2006) outlined three reasons why founding family firms are less likely to manage earnings: 1) long-term business horizon; 2) a higher stake in the firm; and 3) to preserve the family's reputation. Therefore, based on the alignment effect, it is predicted that family ownership is associated with the supply of higher EQ.

On the other hand, the competing view, which is the entrenchment effect, states that family ownership creates incentives for controlling shareholders to expropriate wealth from other shareholders (Fama & Jensen, 1983; Morck *et al.*, 1988; Shleifer & Vishny, 1997). Large shareholders have incentives to maximize their own benefits at the cost of other shareholders (Shleifer & Vishny, 1997). In addition, it has been proven, both theoretically and empirically, that when there is no separation of ownership and control, it will create greater agency conflicts (Fama & Jensen, 1983; Morck *et al.*, 1988). Moreover, the presence of family members on the management and board of directors can cause ineffective monitoring activities and, thus, may result in inferior CG. Accordingly, the entrenchment effect implies that family members have the incentive and are likely to engage in earnings management for private gain because, potentially, there is greater information asymmetry between the family members and other shareholders. Despite the conflicting views, in relation to RPTs, this study proposes the following hypothesis:

H2e: There is a significant positive relationship between RPTs and the EQ of firms with a high percentage of family ownership.

Institutional Ownership

Nowadays, institutional investors have become an important external monitor to protect the interests of minority shareholders. According to Claessens and Fan (2002), in order to mitigate the problems related to conflict of interest between the controlling owners and minority shareholders in Asian firms, the involvement of institutional investors' equity participation may improve CG practices. Mitra and Cready (2005) studied a sample of 136 companies, which belonged to the S&P 500 group and 237 firms that belonged to the non-S&P 500 category for a period of eight years between 1991 and 1998. Their findings showed that active monitoring from the institutional investors helps to prevent managerial opportunistic reporting behavior and improve the quality of governance in the financial reporting process. They also found that institutional shareholders mediate and mitigate the self-serving behavior of corporate managers in financial reporting. Velury and Jenkins (2006) showed significant evidence of

a positive association between institutional ownership and EQ. In addition, Jung and Kwon (2002) reported that, when there is an increase in the holdings of owners, the earnings reported are more informative (Koh, 2007; Park & Shin, 2004).

In the Malaysian context, nowadays, institutional investors have become a large and powerful establishment that plays a significant role in CG to protect the interests of the minority shareholders. As of 2002, the total institutional shareholdings in Malaysia stood at approximately 13% of the total market capitalization of Bursa Malaysia (Abdul Wahab, How, and Verhoeven, 2008). The five largest public institutional investors in Malaysia consist of two pension funds, namely, Employees Provident Fund (EPF) and Lembaga Tabung Angkatan Tentera (LTAT); two investment funds, namely, Permodalan Nasional Berhad (PNB) and Lembaga Tabung Haji (LTH); and an insurance company, the Social Security Organisation (SOCSO). The cumulative shareholdings of these five institutional investors represent approximately 70% of total institutional shareholdings in firms listed on Bursa Malaysia's Main Board (Abdul Wahab *et al.*, 2008). In a different context of study, Abdul Wahab *et al.* (2008) documented that the relationship between institutional ownership and CG is positive and significant based on a sample of 434 companies listed on the Main Board of Bursa Malaysia from 1999 to 2002. The authors found that, on average, a one-standard-deviation increase in CG would result in a 9% increase in institutional ownership. Nonetheless, after the CG reforms in 2001, the relationship became less positive. These findings provide support for the hypothesis that institutional ownership is influenced by CG practices, and it can be concluded that a possible explanation for the less positive relationship is that monitoring by both institutional investors and CG arises at the same time and endogenously after 2001. As such, based on the active monitoring hypothesis notion, and, in relation to RPTs, it is hypothesized that:

H2f: There is a significant positive relationship between RPTs and the EQ of firms with a high percentage institutional ownership.

Audit Quality

Although previous researchers used various proxies for audit quality, including auditor size and audit fees, many prior studies employed auditor size. Unlike other studies, this study employ audit fees to measure audit quality. Many recent studies (see Gul & Tsui, 2001; Nikkinen & Sahlstrom, 2004; Hasnan, Abdul Rahman & Mahenthiran, 2014; Hasnan & Mohamed Hussain, 2015) used audit fees instead of audit firm size as a proxy for the quality of audit services. Several studies have shown that audit fees can better reflect the level of audit quality. The studies conducted by Hay, Knechel, and Wong (2004) and Ferguson, Lennox, and Taylor (2005) confirmed this argument and suggested that auditing is a good example of a service in which price may signal quality. The idea behind these studies is that higher audit fees are expected to require more audit work from the auditor and, thus, contribute to the audit quality.

In addition, prior studies support that audit fees are positively associated with the financial reporting quality. Frankel, Johnson, and Nelson (2002) and Srinidhi and Gul (2007) documented that firms with higher audit fees are likely to report smaller discretionary accruals. In addition, Frankel *et al.* (2002) revealed a negative relationship between audit fees and small earnings

surprises and discretionary accruals. In addition, they found that non-audit fees have a positive relationship with these measures of earnings management. This evidence indicates that higher audit fees are associated with higher quality while higher non-audit fees are related to lower audit quality. Similarly, Srinidhi and Gul (2007) reported that audit fees result in a high quality of reported earnings, whereas non-audit fees result in a low quality of earnings. Therefore, in relation to RPTs, the above discussion leads to the following hypothesis:

H2g: There is a significant positive relationship between RPTs and the EQ in firms with a higher audit quality.

RESEARCH DESIGN

Sample

The sample consists of firms listed on Bursa Malaysia under the Main Market (Main and Second Board) from 2011 to 2012.⁴ Firms listed under ACE Market were excluded from the sample. Table 1 summarizes of the sample selection process. It can be noted that the total number of firms listed on Bursa Malaysia for 2011–2012 is 1,917. However, for the purpose of this study, only companies listed on Bursa Malaysia that distributed circulars to their shareholders pertaining to RPTs during the period under study were selected. This selection is important because the study used circulars to shareholders as the main source for primary data, consistent with Abdul Wahab *et al.* (2011). A total of 1,189 firms were excluded from the sample because the circulars to their shareholders pertaining to RPTs for the period 2011–2012 were not available. This study also follows Peasnell *et al.* (2000) in selecting the sample by restricting financial firms from the sample because of their different governance characteristics and their own specific regulatory and compliance environment. There were 110 firms belonging to the finance industry. As there is a strict data requirement for the accrual quality estimation (to calculate the EQ measure for year 2011–2012, nine years complete accounting data, $t = 2007–2013$), 324 samples were excluded. EQ accounting data were obtained from DataStream and Thomson One Banker; any missing financial data were collected manually from the respective annual reports. As a result, the final sample of this study consists of 294 firms with complete data for EQ, RPTs, and CG variables.

Table 1 Sample Selection

Sample Size	Number of firms
Number of firms listed on Bursa Malaysia in 2011	960
Number of firms listed on Bursa Malaysia in 2012	957
	1,917
Number of firms without RPTs info (Circular)	(1,189)
Finance companies	(110)
Number of firms with incomplete EQ data	(324)
Final sample	294

⁴ Because the collection of data requires a complete data for two years prior and subsequent to the sample year (i.e., $t-2$, $t-1$, t , $t+1$ and $t+2$), the study is only able to select the latest sample up to year 2012 only.

The distribution of sample firms collected are according to their sectors, i.e., construction, consumer product, industrial products, IPC, mining, plantation, properties, technology, and trading and services. This categorization is in accordance with the classification format used by Bursa Malaysia. Table 2 summarizes the distribution of firms in the sample according to their sectors.

Table 2 Sample Distribution

Industry	Number of Firms	
	Total	% of total
Construction	20	6
Consumer product	57	19
Industrial product	95	32
IPC	5	2
Plantation	32	10
Property	14	4
Technology	8	3
Trading & Services	63	21
Total	294	100%

Models and Variables

To investigate the relationship between RPTs and EQ, and to examine whether there is a moderating effect of CG on the relationship between RPTs and EQ, the study uses the following regression model:

$$EQ = \beta_0 \text{Constant} + \beta_1 \text{RPTNO} + \beta_2 \text{RPTASSETS} + \beta_3 \text{DUALITY} + \beta_4 \text{BODIND} + \beta_5 \text{BODSIZE} + \beta_6 \text{CROSSDIR} + \beta_7 \text{FAMILY} + \beta_8 \text{INSTOWN} + \beta_9 \text{AUDQ} + \beta_{10} \text{POLITIC} + \beta_{11} \text{DEBT} + \beta_{12} \text{LNSIZE} + \beta_{13} \text{RPTASSETS} * \text{DUALITY} + \beta_{14} \text{RPTASSETS} * \text{BODIND} + \beta_{15} \text{RPTASSETS} * \text{BODSIZE} + \beta_{16} \text{RPTASSETS} * \text{CROSSDIR} + \beta_{17} \text{RPTASSETS} * \text{FAMILY} + \beta_{18} \text{RPTASSETS} * \text{INSTOWN} + \beta_{19} \text{RPTASSETS} * \text{AUDQ} + \epsilon$$

The independent variables consist of a number of RPTs (RPTNO) and value of RPTs scaled by total assets (RPTASSETS). The regression model also consists of seven CG variables that could moderate the negative effects of RPTs on EQ, namely, CEO duality (DUALITY), board independence (BODIND), board size (BODSIZE), multiple directorships (CROSSDIR), family ownership (FAMILY), institutional ownership (INSTOWN), and audit quality (AUDQ). Specifically, firms are more strongly motivated to engage in RPTs activities and have a better opportunity to manipulate earnings due to poor CG. Therefore, these firms are prone to report a lower quality of earnings. Three variables, namely, politically connected firms (POLITIC), firms leverage (DEBT) and firm size (LNSIZE) are used as the control variables.

Measurement of Dependent Variable: Earnings Quality

The dependent variable used in this study is EQ. EQ is measured by the accrual quality model, as suggested by Francis, LaFond, Olsson, and Schipper (2005), which has been contended by Jaggi *et al.* (2007) as a better proxy for EQ. It is noted that the accrual quality model proposed by Francis *et al.* (2005) is specifically based on the cross-sectional Dechow and Dichev (2002) model, augmented with the fundamental variables from the modified Jones model, namely, plant, property, and equipment (PPE), and change in revenues (all variables are scaled by average assets). McNichols (2002), in her discussion paper of the quality of accruals and earnings, showed that the combination between the original models of Dechow and Dichev (2002), and the variables of Jones (1991) significantly increases the explanatory power of the accrual quality model:

$$\Delta TCA_{j,t} = \phi_{0j} + \phi_{1j} CFO_{j,t-1} + \phi_{2j} CFO_{j,t} + \phi_{3j} CFO_{j,t+1} + \phi_{4j} \Delta REV_{j,t} + \phi_{5j} PPE_{j,t} + v_{j,t},$$

where:

- $\Delta TCA_{j,t}$ = Firm *j*'s total current accruals in year *t*, = $(\Delta CA_{j,t} - \Delta CL_{j,t} - \Delta Cash_{j,t} + \Delta STDEBT_{j,t})$;
- $\Delta CA_{j,t}$ = Firm *j*'s change in current assets between year *t-1* and year *t*;
- $\Delta CL_{j,t}$ = Firm *j*'s change in current liabilities between year *t-1* and year *t*;
- $\Delta Cash_{j,t}$ = Firm *j*'s change in cash between year *t-1* and year *t*;
- $\Delta STDEBT_{j,t}$ = Firm *j*'s change in debt in current liabilities between year *t-1* and year *t*;
- $CFO_{j,t}$ = Firm *j*'s net cash flow from operation in year *t*;
- $CFO_{j,t+1}$ = Firm *j*'s net cash flow from operation in year *t+1*;
- $CFO_{j,t-1}$ = Firm *j*'s net cash flow from operation in year *t-1*;
- $\Delta REV_{j,t}$ = Firm *j*'s change in revenues in year *t-1* and *t*; and
- $PPE_{j,t}$ = Firm *j*'s gross value of PPE in year *t*.

For each firm-year, the equations are estimated cross-sectionally for all firms using the rolling seven-year window (2005–2011). These estimations yield five firm- and year-specific residuals, $v_{j,t}$, $t = t-5, \dots, t$, which form the basis for the accrual metric. Accrual quality $j, t = \sigma(v_{j,t})$ is equal to the standard deviation of firm *j*'s estimated residuals. Larger standard deviations of residuals correspond to poorer accrual quality and vice versa. However, if a firm has consistently large residuals, the standard deviation of these residuals is small, and the firm is considered to have a relatively good accrual quality because there is little uncertainty about its accruals (Francis *et al.*, 2005). For such a firm, the accruals map poorly into cash flows, but this is a predictable phenomenon and should not be a reason for price uncertainty. This study follows DeFond, Hung, and Trezevant (2007) in that the standard deviation score is multiplied by -1 so that a higher score indicates higher EQ.

Measurement of Independent Variables: Related Party Transactions

Data on RPTs were extracted from circulars distributed to shareholders in 2011–2012, which are publicly available from the website of Bursa Malaysia. The study employs both the number and

value of the RPTs to capture their significance. The RPTs are measured using the number of the RPTs, which is similar to the measurement used by Hasnan, Abdul Rahman and Mahenthiran (2013). Consistent with Abdul Wahab *et al.* (2011), the total amount of RPTs scaled with total assets is also examined to measure the importance to the related party, assuming that a higher value of RPTs strengthens any conflicts of interest (Gordon *et al.*, 2004).

Measurement of Moderating Variables: Corporate Governance [CEO duality, board independence, board size, multiple directorships, family ownership, institutional ownership, and audit quality]

Firms have a greater opportunity to engage in RPTs and report lower EQ when firms have poor internal and external CG structures proxied by CEO duality, lack of independent board, larger/lower board size, multiple directorship, high family ownership, and lower audit quality.

With regard to internal governance, DUALITY is a dummy variable, which has a value of 1 if the CEO also serves as the chairman of the board of directors in the firm, and if the posts are separate, it is 0. This measurement is similar to the study by Peasnell *et al.* (2000). Independent directors are expected to improve the level of the compliance of CG by a company because they have integrity, expertise, and independence to align the interests between the management and other shareholders. Consistent with Che Haat, Abdul Rahman and Mahenthiran (2008), board independence (BODIND) is measured by the proportion of independent non-executive directors on the board, which is expressed as a percentage. Board size (BODSIZE) is measured based on the total number of directors sitting on the board of the firm consistent with Abdul Rahman and Mohamed Ali (2006). Consistent with Haniffa and Hudaib (2006), the study measures multiple directorships (CROSSDIR) as the proportion of directors on the board having at least one additional directorship in another company to the total number of directors on the board. The study uses the method adopted by Hasnan *et al.* (2013) in collecting information for family ownership by utilizing the annual reports. The study uses the proportion of shares held by the 10 largest shareholders as a measure of ownership concentration, where a larger percentage indicates greater family interest in the firm.

With respect to external governance, this study employs institutional ownership and audit quality. Similar with Abdul Wahab *et al.* (2008), the study measures institutional ownership (INSTOWN) using a proportion of shares owned by the top five institutional investors to the total number of shares issued. Consistent with Hasnan *et al.* (2013), audit quality (AUDQ) is measured using the ratio of audit fees to the total assets of the firm.

EMPIRICAL RESULT

Descriptive statistics

Table 3 presents the descriptive statistics of EQ, RPTs, and CG variables. As reported in Table 3, the maximum value of residuals for the model of Francis *et al.* (2005) is -0.008, and the mean and median value of EQ for pooled data is -0.041 and -0.032, respectively. On average, the

sample firms record 12.044 number of RPTs (RPTNO), which averages to RM995.311 million (RPTAMT).⁵ This result indicates that the RPTs of Malaysian listed firms for the selected period seems significant because this average represents 55.6% of the total assets (RPTASSETS).

Table 3 Descriptive Statistics

	Mean	Median	Minimum	Maximum	Std. Dev
EQ	-0.041	-0.032	-0.264	-0.008	-0.034
RPTNO	12.044	8.000	1.000	89.000	13.428
RPTAMT ('000)	995311	45375	34.000	95821710	7832401
RPTASSETS	0.556	0.108	0.000	28.004	2.389
DUALITY	0.130	0.000	0.000	1.000	0.332
BODIND	0.447	0.430	0.220	0.830	0.123
BODSIZE	7.708	7.000	4.000	15.000	1.852
CROSSDIR	0.661	0.680	0.000	1.000	0.245
FAMILY	0.092	0.000	0.000	0.731	0.163
INSTOWN	0.036	0.000	0.000	0.296	0.059
AUDQ	0.000	0.000	0.000	0.004	0.000
POLITIC	0.140	0.000	0.000	1.000	0.343
DEBT	0.219	0.212	0.000	0.757	0.162
ASSETS	1587055	479064	41842	34689180	3905140
LNSIZE	13.235	13.0796	10.64	17.36	1.308

EQ = earnings quality measured by accrual quality based on Francis *et al.* (2005) model; RPTNO = number of RPTs, RPTAMT = total value of RPTs; and RPTASSETS = total value of RPTs scaled with total assets; DUALITY = takes the value of 1 if the firm does not separate the CEO and chairman, and "0" otherwise; BODIND = proportion of independent directors on the board; BODSIZE = total number of directors on the board; CROSSDIR = proportion of directors on board having at least one additional directorship in another company to the total number of directors on the board; FAMILY = total percentage of family ownership for top-10 largest shareholders; INSTOWN = proportion of shares owned by five largest institutional investors to the total number of shares issued; AUDQ = ratio of audit fees to total assets; POLITIC = takes the value of 1 if the firm has political connection and "0" otherwise; DEBT = ratio of total debt to total assets; ASSETS = value of total assets; LNSIZE = log of total assets.

For the internal governance, the number of companies that do not separate the roles of the CEO and chairman (DUALITY) is relatively small for the entire two-year period at 13%. This result indicates that role duality is not common in Malaysian firms. Thus, it suggests that most Malaysian firms comply with the recommendation of the MCCG for the separation of the roles of the CEO and chairman. In terms of board composition, the results show that the mean of 44.7% of Malaysian listed companies meets the recommendation of the MCCG to have at least one-third of the board comprise independent nonexecutive directors (BODIND).

The average board size (BODSIZE) of Malaysian companies is 7.708 while the median is 7.000, and the size of board ranges between 4 and 15 board members. This is similar to the studies of Haniffa and Hudaib (2006) and Abdul Rahman and Mohamed Ali (2006) in that the average board size of Malaysian companies is eight directors. In addition, the size also is within the range recommended by Jensen (1993) for board effectiveness. In terms of multiple

⁵ For a comparison of RPTAMT/connected transactions among countries see OECD (2009) for China, Kuan, Li, and Chu (2010) for Indonesia; Cheung, Jing, Rau, and Stouraitis (2006) for Hong Kong; Gallery, Gallery, and Supranowicz (2008) for Australia.

directorships (CROSSDIR), more than half of the board members (66.1%) hold additional directorships in other firms. With regard to family ownership, the percentage ranges from 0% to 73.1%. Surprisingly, only 9.2% of the sample firms are family firms (FAMILY). This result is not consistent with prior studies (Claessen *et al.*, 2000; Munir & Mohd Salleh, 2009) that report that the majority of Malaysian firms are family owned. One possible explanation is because of the different samples used in the study, in which family-owned firms that did not issue circulars to shareholders during period of the study were excluded.

With respect to external governance, the percentage of institutional ownership for the sample average is 3.6% with a maximum of 29.6%, while the ratio of audit fees to total assets ranges from 0.000 to 0.004. With respect to political connection (POLITIC), an average of 14% of the firms are politically connected, while the ratio of total debt to total assets (DEBT) stands at 0.219. The sample firms average RM 1.587 billion with a maximum of RM 34.68 billion, indicating that the sample firms in this study that engage in RPTs activities are the larger firms.

Univariate Analysis

Table 4 presents the correlation results of the variables in the test models. The correlation between EQ and RPTNO are negative but insignificant. Similarly, the results also report a negative correlation between EQ and RPTASSETS, with the Pearson correlation significant at the 1% level. This finding gives initial support to the earlier argument concerning the conflict of interest raised by Gordon *et al.* (2004) and supports Gordon and Henry (2005) in that there are incentives for the board members or officers to use RPTs to expropriate perquisites for their private gain. Hence, the possibility of them managing the earnings is higher to conceal the transactions pertaining to expropriation, which will affect the quality of the reported earnings of the firms.

As illustrated in Table 4, DUALITY, CROSSDIR, and DEBT are significantly related to EQ. Interestingly, the study finds that DUALITY is positively correlated with EQ, which indicates that firms with a duality role will report a high quality of earnings. This result contradicts the argument concerning the conflict of interest in the agency theory, which supports that having the same person holding two top positions is likely to provide an incentive for him/her to work against the interests of the company (Abdullah, 2004; Abdul Rahman & Haniffa, 2005). However, this result is supported by Abdoli and Royae (2012), who find evidence that EQ in Iranian firms without role duality decreases. Next, CROSSDIR is reported to be negatively correlated with EQ. Similar to Ferris *et al.* (2003), this result indicates that firms having directors with multiple directorships may result in board members becoming distracted due to being too busy and that this may reduce their ability to effectively monitor the management of the firm, thus affecting the financial reporting process. Additionally, the study also finds a positive correlation between EQ and various CG mechanisms, namely, board size, family ownership, institutional ownership, and audit quality. However, the results show an insignificant relationship.

With respect to the control variables, the correlation analysis shows a positive but insignificant relationship for POLITIC, firm size (LNSIZE), and EQ. This indicates that

politically connected firms and bigger firms are likely to have better EQ compared with non-politically connected firms and smaller firms. The possible explanation is because politically connected firms are given preferential access to government projects, subsidies, and distress lending and, hence, are unconstrained by barriers to competition (Hasnan *et al.*, 2013). Thus, they are able to maintain the quality of their reported earnings. Furthermore, as stated by Park and Shin (2004), bigger firms are likely to report a higher quality of earnings because they are closely followed by the external capital market. Firms leverage (DEBT) is found to be negatively correlated with EQ, suggesting that firms facing financial problems are likely to manage earnings (Jaggi *et al.*, 2007; Wang, 2006).

Multivariate Analysis

Results of the Number of Related Party Transactions (RPTNO)

Table 5 presents the regression results for testing hypothesis H1 when the study employs RPTNO as the main independent variable for RPTs. The results in Table 5 show the adjusted R^2 of 2.4%, which indicates that the RPTNO and control variables contribute about 2.4% to changes in EQ. The adjusted R^2 in this model is considered low. However, other Malaysian studies in the area of earnings quality/management⁶ also report a low adjusted R^2 . Munir and Mohd Salleh (2009), in their study on the association among RPTs, family ownership, and EQ report an adjusted R^2 of 6.5%. However, a study by Abdullah (2004), who examined the relationship between CG mechanisms and EQ measured by the earnings response coefficient (ERC), reported an adjusted R^2 of 7.1%.

The results in the study also show that RPTNO is negatively associated with EQ. However, the result is not significant (0.98). It is to be emphasized that the coefficient direction of RPTNO is as per expectation. With respect to the number of transactions, the study fails to find a significant relationship between RPTs and EQ. In a different context of the study, the findings by Kohlbeck and Mayhew (2004), Gordon *et al.* (2004), Ryngaert and Thomas (2007), and Abdul Wahab *et al.* (2011) indicate a negative association between RPTNO and firm performance, measured by ROA.

⁶ The terms “earnings quality” and “earnings management” are used interchangeably in prior studies because higher earnings quality represent lower earnings management and vice versa. Thus, research on earnings management also can be referenced in the earnings quality study.

Table 4 Pearson Correlation Matrix of Variable Used in The Study for Sample Firms (2011–2012, N=294)

	EQ	RPTNO2	RPTASSETS	DUALITY	BODIND	BODSIZE	CROSS	FAMILY	INSTOWN	AUDQ	POLITIC	DEBT	LNSIZE
EQ	1												
RPTNO	-0.020	1											
RPTASSETS	-0.239***	0.081	1										
DUALITY	0.122**	-0.072	-0.049	1									
BODIND	-0.036	-0.059	-0.036	-0.109*	1								
BODSIZE	0.065	-0.066	0.028	-0.079	-0.229***	1							
CROSSDIR	-0.097*	0.071	0.039	-0.152***	0.176***	-0.005	1						
FAMILY	0.037	-0.066	-0.076	0.047	-0.234***	-0.071	-0.186***	1					
INSTOWN	0.079	-0.009	0.232***	-0.046	-0.052	0.103*	0.057	-0.159***	1				
AUDQ	0.076	0.010	-0.076	0.030	-0.157***	-0.224**	-0.128**	0.164***	-0.017	1			
POLITIC	0.047	0.012	-0.059	-0.091	0.084	0.143*	0.113*	-0.047	0.056	-0.167***	1		
DEBT	-0.133**	0.045	-0.103*	0.112*	0.032	0.061	0.000	0.135**	-0.173***	-0.085	0.091	1	
LNSIZE	0.022	0.149**	0.069	-0.026	0.251***	0.323***	0.242***	-0.219***	0.229***	-0.487***	0.295***	0.174***	1

Notes: ***:significant at 0.01 level (2-tailed), **: significant at 0.05 level (2-tailed), and *:significant at 0.1 level (2-tailed).

EQ = measured by accrual quality based on Francis *et al.* (2005) model; RPTNO = number of RPTs; RPTASSETS = total value of RPTs over total assets; DUALITY = takes the value of 1 if the firm does not separate the CEO and chairman and "0" otherwise; BODIND = proportion of independent directors on the board; BODSIZE = total number of directors on the board; CROSSDIR = proportion of directors on board having at least one additional directorship in another company to the total number of directors on the board; FAMILY = total percentage of family ownership for top ten largest shareholders; INSTOWN = proportion of shares owned by five largest institutional investors to the total number of shares issued; AUDQ = ratio of audit fees to total assets; POLITIC = takes the value of 1 if the firm has political connection and "0" otherwise; DEBT = ratio of total debt to total assets; LNSIZE = log of total assets

Table 5 Regression Results for Earnings Quality and Number of Related Party Transactions

Variables	Model 1	
	Coefficient	t-statistic
(Constant)	-0.647	-0.985
RPTNO	-0.001	-0.024
POLITIC	0.132	0.744
DEBT	-0.670	-1.862*
LNSIZE	0.069	1.343
Industry fixed (dummy variable)	Yes	
Adjusted R ²	0.024	
F-statistic	1.699*	
Firm-years	294	

Notes: ***Significant at 0.01 level; **Significant at 0.05 level; and *Significant at 0.10 level.

EQ = measured by accrual quality based on Francis *et al.* (2005) model; RPTNO = number of RPTs; POLITIC = takes the value of 1 if the firm has political connection; DEBT = ratio of total debt to total assets; and LNSIZE = log of total assets

Results of Value of Related Party Transactions (RPTASSETS)

Table 6 shows the regression results when the study employs the value of RPTs scaled with total assets (RPTASSETS) as the main independent variable for RPTs. In relation to Model 2, Table 6 shows the adjusted R² of 4.3%. RPTASSETS, which is negative and significantly related to EQ. This finding indicates that the higher the value of RPTs, the less the quality of reported earnings. Thus this suggests that RPTASSETS is a better measurement for RPTs. The findings are consistent with Gordon and Henry (2005), who revealed that board members/executives use RPTs to expropriate the firm's resources and later manage the earnings to conceal such expropriation. Based on the argument of Gordon and Henry (2005), RPTs are harmful to shareholders and negatively impact the quality of reported earnings. The findings also give support to the argument concerning the conflict of interest raised by Gordon *et al.* (2004). In a different context of study, the results are consistent with several studies, which explore the relationship between RPTs and firm performance, measured by ROA (see, e.g., Gordon *et al.*, 2004; Ryngaert & Thomas, 2007). In the context of the study on Malaysia, Abdul Wahab *et al.* (2011) revealed that, when the amount is concerned, RPTs are negatively associated with firm performance.

Table 6 Regression Results for Earnings Quality and Value of Related Party Transactions

Variables	Model 2	
	Coefficient	t-statistic
(Constant)	-0.624	-0.983
RPTASSETS	-0.149	-2.362**
POLITIC	0.135	0.770
DEBT	-0.842	-2.314**
LNSIZE	0.072	1.459

Table 6 (Cont.)

Industry fixed (dummy variable)	Yes
Adjusted R ²	0.043
F-statistic	2.209**
Firm-years	294

Notes: ***Significant at 0.01 level; **Significant at 0.05 level; and *Significant at 0.10 level.

EQ = measured by accrual quality based on Francis *et al.* (2005) model; RPTASSETS = total value of RPTs scaled by total assets; POLITIC = takes the value of 1 if the firm has political connection and “0” otherwise; DEBT = ratio of total debt to total assets; and LNSIZE = log of total assets

Results of Moderating Variables

Table 7 summarizes the regression results for Model 3 and Model 4 when RPTNO is used as a main independent variable. These models are regressed to test the moderating effects of the CG variable on the relationship between RPTs and EQ. Model 3 represents the main regression model, while Model 4 includes the interaction term of RPTNO and CG variable. In relation to Model 3, Table 7 shows the adjusted R² of 7.5%, which implies that, based on this model, 7.5% of variations in EQ are influenced by the independent, moderating, and control variables. The adjusted R² in this study may be considered low. However, with regards to the studies on Malaysia, which examine the relationship between CG mechanisms and earnings management, Abdullah and Mohd Nasir (2004) and Abdul Rahman and Mohamed Ali (2006) also reported a low adjusted R², which is 5.33% and 12.8%, respectively. Next, the results in Model 3 show that the coefficient of RPTNO is positive and insignificant with EQ. The findings also show a significant and positive association among EQ, DUALITY, BODIND, BODSIZE, and AUDQ, whereas DEBT shows a significant result at the 0.01 significant level with EQ. However, the results indicate insignificant results among EQ and CROSSDIR, FAMILY, INSTOWN, POLITIC, and LNSIZE.

With respect to Model 4, the main regression model (Model 3) is regressed together with the inclusion of the interaction of RPTNO and four CG variables: CEO duality, board independence, board size, and audit quality. This is because the remaining three CG variables are not found to be significant; thus the study cannot interact them with RPTNO. Contrary to Model 3, Model 4 presents the results of RPTNO, which is negatively associated but still insignificant with EQ. The study finds that the moderating variables (DUALITY, BODIND, BODSIZE, AUDQ, and DEBT) remain significantly related with EQ, thus demonstrating the robustness of the models used. The results for the remaining variables are similar to that of Model 3.

However, concerning the interaction variables of the RPTNO with CG variables, the study only finds that the interaction of RPTNO*AUDQ is positively and significantly associated with EQ. The results explain that high audit quality (proxy by audit fees) mitigates the negative impact of RPTs on the quality of reported earnings. This result also indicates that higher audit fees for firms with RPTs signify greater audit effort. From a risk-based perspective, for firms with poor governance, the auditors are likely to increase the audit effort; therefore, the audit fees will be higher. The results of this study are consistent with Gul, Lynn, and Tsui (1999) who reported that audit quality mitigates the negative association between management ownership

and the magnitude of discretionary accruals in Australian firms. In addition, the findings fill the gap in the evidence provided by Abdul Wahab *et al.* (2011), who reported that the interaction of audit quality proxy by audit firm size with RPTNO is positive but insignificant with firm performance. The evidence in this study supports the findings of Abdul Wahab *et al.* (2011), Fan and Wong (2005), and Chien and Hsu (2010) that external auditors do play a governance role. Thus, the study accepts hypothesis H2g.

Concerning the moderating role of CEO duality, board independence, and board size, as the internal CG mechanism, hypotheses H2a, H2b, and H2c are rejected due to the insignificant results. Nevertheless, the results provide a positive coefficient, suggesting that these three governance mechanisms could minimize the negative effects of RPTs. In a different context of study, Abdul Wahab *et al.* (2011) suggested that the positive coefficient could reduce the negative effects of RPTs on firm performance.

Table 7 Regression Results for Model 3 and 4

Variable	Model 3		Model 4	
	Coefficient	t-statistic	Coefficient	t-statistic
(Constant)	-1.461	-1.692*	-1.353	-1.518
RPTNO	0.041	0.668	-0.171	0.712
DUALITY	0.470	2.657**	0.408	2.287**
BODIND	0.892	1.611*	1.010	1.771*
BODSIZE	0.145	2.089**	0.156	2.191**
CROSSDIR	-0.306	-1.258	-0.269	-1.099
FAMILY	0.090	1.139	0.082	1.030
INSTOWN	0.023	0.306	0.016	0.216
AUDQ	0.227	2.773**	0.206	2.496**
POLITIC	0.210	1.206	0.194	1.108
DEBT	-0.951	-2.576**	-0.850	-2.241**
LNSIZE	0.112	1.574	0.100	1.334
RPTNO*DUALITY			0.233	0.902
RPTNO*BODIND			0.457	0.869
RPTNO*BODSIZE			0.052	0.691
RPTNO*AUDQ			0.132	2.118**
Industry fixed (dummy variable)	Yes		Yes	
R square	0.132		0.150	
Adjusted R ²	0.075		0.081	
F-statistic	2.315***		2.170***	

Notes: ***Significant at 0.01 level; **Significant at 0.05 level; and *Significant at 0.10 level.

EQ = measured by accrual quality based on Francis *et al.* (2005) model; RPTNO = number of RPTs; DUALITY = takes the value of 1 if the firm does not separate the CEO and chairman and "0" otherwise; BODIND = proportion of independent directors on the board; BODSIZE = total number of directors on the board; CROSSDIR = proportion of directors on board having at least one additional directorship in another company to the total number of directors on the board; FAMILY = total percentage of family ownership for top 10 largest shareholders; INSTOWN = proportion of shares owned by five largest institutional investors to the total number of shares issued; AUDQ = ratio of audit fees to total assets; POLITIC = takes the value of 1 if the firm has political connection and "0" otherwise; DEBT = ratio of total debt to total assets; LNSIZE = log of total assets.

Table 8 shows the regression results for the interaction of CG mechanisms and RPTASSETS to determine its impact on the EQ. Model 5, as the main regression model, is regressed with the inclusion of the independent, moderating, and control variables. While, in Model 6, the study includes all the interaction variables of RPTASSETS and seven CG variables. In relation to Model 5, Table 8 shows the adjusted R² of 8.4%, which indicates that the independent, moderating, and control variables contribute about 8.4% of the change in EQ. Next, the results show that EQ is negatively and significantly associated with RPTASSETS. Model 5 also shows positive and significant results among EQ, DUALITY, BODSIZE, and AUDQ. In addition, the results state that DEBT is significantly and negatively related to EQ. Further, the main regression model (Model 5) also reports a positive and significant result between LNSIZE and EQ.

With respect to Model 6, the results state that the adjusted R² is 8.4%. Similar to Model 5, the main independent variable (RPTASSETS), and the moderating and control variables in Model 6 show the same results. DUALITY, BODSIZE, AUDQ, DEBT, and LNSIZE are found to be significantly related to the quality of reported earnings. The results from the regression analysis report that the interaction terms of board independence and RPTASSETS are significantly related to EQ. The results indicate that the quality of board independence as the moderator does have a significantly positive effect on the relationship between RPTs and EQ, as the interaction term (RPTASSETS*BODIND) is positive and significant. In a different context of study, Abdul Wahab *et al.* (2011) also reported that the level of board independence mitigates the negative impact of the RPTs on firm performance, when the amount concerned is measured by ROA. In addition, the findings by Chien and Hsu (2010) are consistent with Abdul Wahab *et al.* (2011). Chien and Hsu (2010) supported the efficient transactions hypothesis that RPTs with independent boards and supervisors are helpful to the company's interests. The finding of a positive association between the independent board and the quality of reported earnings is also similar to the study conducted by Abdullah (2004), who found a positive and significant result between the role of independent directors and EQ in Malaysian firms. Thus, hypothesis H2b is supported.

Furthermore, the study finds that an external governance mechanism, AUDQ, also reduces the negative impact of RPTs on EQ, as the interaction term, RPTASSETS*AUDQ, is positive and significant. These findings are consistent with the results in Table 5 when RPTNO is employed as the main independent variable for RPTs. Thus, the study provides concrete evidence that audit quality (proxy by audit fees) plays a positive moderating role in mitigating the negative impact of RPTs on EQ. Gul *et al.* (1999) also documented that audit quality weakens the negative association between low director ownership and discretionary accruals. In a different context of study, the evidence provided by Abdul Wahab *et al.* (2011) and Chien and Hsu (2010) also indicated that audit quality reduces the negative relationship between RPTs and performance (ROA) when the value of RPTs is concerned.

Although DUALITY and BODSIZE are found to be significantly related with EQ, the results are inconsistent with the expectation pertaining to the interaction with RPTASSETS, in that (i.e., RPTASSETS*DUALITY, RPTASSETS*BODSIZE) are not significantly related to EQ. Nevertheless, it should be noted that the prediction sign of the coefficient is as per the prediction, which is positive. Hence, this could suggest that role duality and board size could

help to reduce the negative effects of RPTs on the quality of reported earnings. The remaining interaction variables (i.e., RPTASSETS*CROSSDIR and RPTASSETS*INSTOWN) are not found to be significantly related to EQ.

Table 8 Regression Results for Model 5 and 6

Variable	Model 5		Model 6	
	Coefficient	<i>t</i> -statistic	Coefficient	<i>t</i> -statistic
(Constant)	-1.493	-1.786*	-1.759	-1.979**
RPTASSETS	-0.116	-1.814*	-0.559	-1.963*
DUALITY	0.444	2.519**	0.480	2.686**
BODIND	0.549	0.991	0.796	1.373
BODSIZE	0.127	1.888*	0.123	1.788*
CROSSDIR	-0.277	-1.147	-0.334	-1.368
FAMILY	0.076	0.971	0.072	0.898
INSTOWN	0.020	0.267	0.024	0.320
AUDQ	0.215	2.632**	0.217	2.532**
POLITIC	0.215	1.239	0.176	0.995
DEBT	-1.070	-2.872***	-1.006	-2.651**
LNSIZE	0.129	1.890*	0.145	1.981*
RPTASSETS*DUALITY			0.222	1.116
RPTASSETS*BODIND			0.997	1.814*
RPTASSETS*BODSIZE			0.044	0.682
RPTASSETS*CROSSDIR			-0.056	-0.228
RPTASSETS*FAMILY			0.069	0.700
RPTASSETS*INSTOWN			0.106	1.539
RPTASSETS*AUDQ			0.110	1.726*
Industry fixed (dummy variable)	Yes		Yes	
R square	0.140		0.162	
Adjusted R ²	0.084		0.084	
F-statistic	2.496***		2.079***	

Notes: ***Significant at 0.01 level; **Significant at 0.05 level; and *Significant at 0.10 level.

EQ = measured by accrual quality based on Francis *et al.* (2005) model; RPTASSETS = total value of RPTs scaled with total assets; DUALITY = takes the value of 1 if the firm does not separate the CEO and chairman and “0” otherwise; BODIND = proportion of independent directors on the board; BODSIZE = total number of directors on the board; CROSSDIR = proportion of directors on board having at least one additional directorship in another company to the total number of directors on the board; FAMILY = total percentage of family ownership for top 10 largest shareholders; INSTOWN = proportion of shares owned by five largest institutional investors to the total number of shares issued; AUDQ = ratio of audit fees to total assets; POLITIC = takes the value of 1 if the firm has political connection and “0” otherwise; DEBT = ratio of total debt to total assets; LNSIZE = log of total assets

CONCLUSION

This study attempts to examine the relationship between related party transactions and earnings quality and to investigate whether corporate governance has a positive moderating effect on the relationship between related party transactions and earnings quality. The motivation behind this study is the emphasis on the issue of related party transactions constituting one of the ways for the expropriation of wealth by the controlling shareholders from the shareholders of the firm, especially minority shareholders. Based on 294 firm-years listed on Bursa Malaysia for 2011–2012, the study finds a negative relationship between related party transactions and earnings quality. In addition, the study finds that board independence and audit quality do matter in mitigating the negative impact of related party transactions. The findings are consistent with the extant literature on the relationship between related party transactions and earnings management (Gordon & Henry, 2005) and the association between related party transactions and firm performance (Gordon *et al.*, 2004; Kohlbeck & Mayhew, 2004; Ryngaert & Thomas, 2007; Abdul Wahab *et al.*, 2011), thus supporting the conflict of interest argument. Nevertheless, the study finds that CEO duality, size of board, multiple directorships, family ownership, and institutional ownership are irrelevant in moderating the relationship between related party transactions and earnings quality.

A limitation of this study is that this study ignores the various types of related transactions. Cheung *et al.* (2006) suggested that some types of transaction could actually benefit the shareholders. Additionally, this study also failed to take into consideration the parties involved in the related transactions. Furthermore, the sample size could be relatively small, and companies, which were included in the sample, were not selected through random sampling. Rather, the companies were selected based on the availability of the data in calculating the accrual quality variable. The selection process may be biased toward the surviving firms because there are strict requirements for the accrual quality estimation that requires a minimum of seven years complete financial data.

Future research could perhaps consider employing various types of related party transactions to understand the impacts on earnings quality. In addition, future studies are also encouraged to adopt other corporate governance mechanisms as the moderating variables, such as characteristics of audit committee, because the role of overseeing the financial reporting process has been delegated to the audit committee. In addition, directors' remuneration can be tested to determine its link to related party transactions and quality of reported earnings. It would be interesting to know the impact of these variables on the quality of reported earnings. Following past studies (Wong & Jian, 2003; Aharony *et al.*, 2005), it would be interesting for future studies to be conducted on Malaysian IPO firms. It is possible that Malaysian IPO firms with related party transactions would have a different impact on the quality of reported earnings. As the current study used the accrual quality model of Francis *et al.* (2005) to measure earnings quality, it is suggested that future studies test the relationship examined in this study using different proxies for earnings quality, such as performance-adjusted current discretionary accruals, as suggested by Kothari, Leone, and Wesley (2005). It is essential to note that researchers have not determined a uniform method to measure earnings quality.

Therefore, the existing findings of this study could be validated by testing the relationship using different proxies for earnings quality.

The study suggests that the quality of reported earnings is lower in a firm with the presence of related party transaction activities. Thus, the findings of this study serve as a wake-up call for the regulatory bodies (i.e., securities commissions and MSWG) to monitor and prevent such transactions from occurring to protect the interests of the minority shareholders. In addition, this study raises concerns as to whether the rules and requirements set by the regulators are applicable and effectively deal with related party transactions. Furthermore, the findings of this study identify the requirement for improved corporate governance practices among Malaysian firms.

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