RELATED PARTY TRANSACTIONS AND EARNINGS MANAGEMENT

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Abstract

This study examines the association between related party transactions and earnings management, based on a sample of 50 Indonesian publicly listed companies for the periods ending 2004 and 2005. The hypothesis developed in this study draw on past literature and the tenets of agency theory which suggest that the existence of related party transactions represent potential conflict of interest which may results in earnings management and appropriation by controlling shareholder to minority shareholders. The empirical findings of the study suggest that there is no statistically significant evidence of the association between related party transactions and earnings management attributes. Additional sensitivity analysis conducted with alternative measures of earnings management and related party transactions confirm the initial regression results. The results of this study suggest that the mere presence of related party transactions in Indonesian companies does not necessarily indicate that management engage in greater earnings management. This study provides a valuable starting point for similar research in other developing countries.

Keywords: *Earnings management; Related party transactions; Indonesia*

Abstrak

Penelitian ini menguji hubungan antara transaksi-transaksi diantara pihak-pihak yang berhubungan dan manajemen laba, berdasarkan data dari 50 perusahaan yang terdaftar di pasar modal dalam periode 2004 dan 2005. Hipotesis dibangun dari penelitian-penelitian sebelumnya yang terkait dengan teori keagenan yang menyatakan bahwa keberadaan transaksi-transaksi diantara pihak-pihak yang berhubungan berpotensi untuk menimbulkan konflik kepentingan sehingga menghasilkan manajemen laba dan kecenderungan pengendalian pemegang saham untuk pemegang saham minoritas. Temuan empiris dari studi menunjukkan bahwa tidak ada bukti statistik yang signifikan dari hubungan antara transaksi pihak terkait dan atribut manajemen laba. Sensitivitas analisis tambahan dilakukan dengan langkah-langkah alternatif pendapatan manajemen pemerintah dan transaksi pihak terkait mengkonfirmasi hasil regresi awal. Hasil studi ini menunjukkan bahwa Kehadiran transaksi pihak terkait di perusahaan-perusahaan Indonesia tidak selalu menunjukkan bahwa manajemen laba yang lebih besar. Studi ini merupakan titik awal yang berharga untuk penelitian serupa di negara-negara berkembang lainnya.

Kata Kunci: *manajemen laba, transaksi pihak terkait, Indonesia*

INTRODUCTION

The purpose of this study is to investigate whether there is an association between related party transactions (RPTs)[1] and earnings management (EM)[2] in Indonesian publicly listed companies. The hypothesis is based on agency theory tenets concerning the separation of ownership, conflict of interest and information asymmetry. This study utilises a sample of Indonesian publicly listed companies for the periods ending 2004 and 2005. The modified Jones (1991) accruals[3] estimation model is used to measure discretionary accruals (the proxy for EM).

EM and RPTs are very important aspects of financial reporting over the years and have been under intense media after a series of spectacular corporate collapses (e.g. Enron using their Special Purpose Entities) (Jian and Wong, 2004). These RPTs are usually complex and differ between companies depending on factors such as the ownership structure and the nature of the business. Gordon and Henry (2005: 1) argues that," users of financial reports view the existence of RPTs as an indicator of increased likelihood of aggressive accounting". Furthermore, American Institute of Certified Public Accountants (AICPA) suggests that one of the important and difficult aspects of financial statement audit is the identification of related parties and transactions with related parties. "Related parties such as controlled entities, principal stockholders or management can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud the company by transferring funds to conduit related parties and ultimately the perpetrators" (AICPA, 2001, p.5).

As a result of the increase significance of these issues, government and standard setters have increased the emphasis of regulations on RPTs as can be seen in the United States Sarbanes-Oxley Act (2002), the Australian Commonwealth Government's Corporate Law and Economic Reform Program (CLERP 9) and Australian Securities and Investment Commissions' (ASIC) (2005) campaign. The Sarbanes-Oxley Act (2002) amended disclosure requirements of RPTs via the Section 402 provisions with enhanced conflict of interest disclosures. The CLERP 9 Bill set out that government proposed legislative response on corporate disclosure including the disclosure of the executive remuneration and policies (Allens, et al., 2003). Furthermore, ASIC have announced campaign to crack down on related party (RP) disclosure documents and to ensure that shareholders receive sufficient information to make a decision about whether to grant RP benefits (ASIC, 2005).

EM is a vibrant area in accounting research. There are numerous publications and research which examine EM by measuring companies' discretionary accruals (Jones, 1991). These publications investigate the relation of EM with respect to many issues such as auditor independence (Frankel, Johnson, and Nelson, 2002), auditor specialization (Krishnan, 2003) and corporate governance (Peasnell, et al., 2006). However, research published regarding the issue of EM with RPTs are still limited. Although there are studies conducted to investigate the issue of RP and tunneling[4], they focus on the market valuation effects of this behaviour (Claessens, et al., 2000). This study seeks to fill the gap in the literature through the investigation of RPTs and EM in Indonesian publicly listed companies.

Several studies found that Indonesia has characteristics that might indicate high level of RPTs and EM. Past researchers propose that Indonesia has high concentration level of ownership (La Porta, et al., 1999; Claessens, et al., 2000), low level of transparency and disclosure quality[5] (Fan and Wong, 2002), low efficiency of judicial system, low rating in rule of law, significantly high corruption level and moderate risk of expropriation (La Porta, et al., 1999). According to Leuz, et al., (2003: 508), "earnings management is more pervasive in countries [like Indonesia[6]] where the legal protection of outside investor is weak, because in these countries insider enjoy greater private control benefits and hence have stronger incentives to obfuscate firm per-

formance"[7]. These characteristics that Indonesia possessed indicate possible high levels of RPTs consequently high level of EM. Indonesia thus provides an important setting to test the association between EM and RPTs.

This study contributes to the accounting literature in several ways. Firstly, this study provides further evidence on the association of RPTs with EM[8]. Despite worldwide media and government attention over the concern of RPTs involved in recent corporate collapses, there is little rigorous academic research conducted to investigate the extent of RPTs in companies and their underlying nature (Gordon, et al., 2004; Jian and Wong, 2004). Secondly, this is the first known study of RPTs and EM that focuses on Indonesia. Previous studies of RPTs and EM have looked at countries such as China (Jian and Wong, 2004; Aharony, et al., 2005). Our study examines the different impact of using RPTs to manage earnings in emerging country of Indonesia with different characteristics such as ownership structure, disclosure quality, investor protection, corporate government, and legal enforcement. Furthermore, this research provides an overview on the actual RPTs in Indonesia and as an important basis for future research in Indonesian context.

The remainder of this paper is organised as follows. The next section presents the theoretical framework underlying RPTs and EM linkage. Hypothesis is also provided in the next section. Section Three describes the research design. Primary results including descriptive statistics, correlations and regression analysis are presented in Section Four. Results of the study and implications for future research are discussed in the concluding section.

THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

The majority of the literature that seek to explain the incentives of managing earnings utilised agency theory. Agency theory is the major theory that serves as a basis for this research and hypothesis development. Jensen and Meckling (1976) argue that agency conflict exists between the manager and shareholder due to the separation of ownership and control. Agency theory focuses on the relationship[9] between principal and agents (for example the relationship between shareholders and corporate managers), a relationship that created much uncertainty due to information asymmetry between two parties. The study of EM and RPTs presents an excellent opportunity to apply agency theory in a sense that there is conflict of interest and information asymmetry between controlling and minority shareholders in Indonesian companies that facilitate the controlling shareholders to act in a self-interest way such as manage earnings for their own benefits.

Furthermore, as implied by the media and standard setters, RPTs represent the potential expropriation of the firm's resources (Gordon and Henry, 2005)[10]. Kohlbeck and Mayhew (2004) propose that RPTs also raise concerns based on agency theory that managers will over consume perquisites (i.e. inappropriate wealth transfer) and alter the reliability of financial statements thereby reducing the effectiveness of contracts designed to reduce agency conflicts and damages the firm's stakeholders (Jensen and Meckling, 1976). The results of study conducted by Gordon, et al.(2004) also provide support for the view of RPTs as conflict of interest between managers/board members and their shareholders.

There are several past studies that focus on the cost and benefits of corporate groups (Khanna and Palepu, 1997; Fishman and Khanna, 1998; Claessens, et al., 2006). However, association between RPTs and EM is a relatively new topic in accounting research. There are limited studies conducted on these issues and the results are mixed and far from conclusive. Carmichael (1999) proposes that there is a long history of revenue-recognition manipulations involving related parties that are connected with fraudulent financial reporting. The study conducted by Jian and Wong (2004) look into whether and how controlling shareholders use RPTs in EM and tunneling as well as the market response to such activities in China. It is found that the group-controlled firms report an abnormally

high level of RP sales when they have the incentives to inflate earnings in order to meet government requirements for the new equity offerings or to avoid delisting (Jian and Wong, 2004). This study provides direct evidence on how large shareholders expropriate minority shareholders. In addition, Aharony et al.(2005) investigates RPTs as a means of EM and tunneling during IPO process in China. Their paper contributes by providing empirical evidence on earnings management using RPTs by examining RPTs patterns in both pre- and post-IPO periods and enhances understanding of the motives of earnings manipulation in the pre-IPO period.

More recent study, such as Ashbaugh-Skaife *et al.*(2006) suggests that when there is no or little scrutiny over RPTs, the manager has greater incentives to expropriate firm resources and manage earnings. Cheng and Chen (2007) research of Chinese IPO firms, argue that there are two ways for IPO firms to manipulate pre-IPO reported earnings, by manipulating discretionary accruals and structuring artificial operating RPTs (non-loan) with controlling shareholders. Gordon and Henry (2005) propose that if managers engage in RPTs to expropriate the firm's resources, then they have the incentives to manage earnings to mask such expropriation. On the contrary, Gordon and Henry (2005) conclude that concerns about RPTs are warranted but only for certain transactions and the mere presence of RPTs is not necessarily an indication that a firm is likely to engage in greater EM. Kohlbeck and Mayhew (2004) suggest that RPTs with investments appear to be associated with efficient contracting, while simple transactions with directors, officers and shareholders are associated with opportunism. According to Duprey (2006), although most of the RPTs are legal, often these transactions were supposed to be conducted at arm's length but ultimately benefited several of the principals involved. He also suggests that RPTs will be more prevalent in a family-owned and operated business.

In brief, most of the studies conducted focus on RPTs with respect to EM on IPO period and/or China. The majority of these studies suggest that there is empirical evidence that Chinese firms use RPTs as a means of EM and tunneling during IPO process. Given that there is no known prior study that utilise Indonesian data, this study seeks to provide a more comprehensive picture of RPTs and EM in Indonesian firms.

Dye (1988) and Trueman, et al.(1988) show analytically that the existence of information asymmetry between management and shareholders is a necessary condition for EM. Lobo and Zhou (2001) argue that in such environment where shareholders they have less information than management and cannot perfectly observe a firm's performance, management can use its flexibility to manage reported earnings.

In relation to concentrated ownership, McCahery and Vermeulen (2005) suggest that inefficient controlling shareholders have given rise to a huge variety of sophisticated techniques to tunnel assets, profits and corporate opportunities. Fan and Wong (2002) propose that when ownership is concentrated to a level at which an owner obtains effective control of the firm, as the case in East Asia (like Indonesia[11]), the nature of the agency problem shifts away from manager-shareholder conflicts to conflicts between the controlling owner (who is also the manager) and minority shareholders. This view is further justified by the study conducted by Lukviarman (2004) on Indonesian ownership structure and firm performance. Lukviarman (2004) finds that only a small proportion of private-domestic Indonesian firms have a widely dispersed ownership structure and the agency problem shifted to strong controlling shareholders and weak minority owners. Furthermore, the study proposes that inappropriate institutional, law and legal enforcement insulate the controlling shareholders from external interference, monitoring and supervision. In another Indonesian study, Patrick (2002) suggests that Indonesian stock exchange, self-regulating institutions, and government oversight practice are not strong. Thus, highly concentrated and family-based ownership structure leaves corporate

decisions in the hands of the controlling family which might use RPTs to serve their own self-interested purpose.

Accordingly, it can be inferred that Indonesian country characteristics facilitates EM. Furthermore, agency theory suggests that company management as agent is driven by their self-interest in concentrated ownership company (controlling shareholder). Consequently, this study conjecture that companies with perceived high level of RPTs might use the RPTs as a means to manipulate earnings for outright appropriation or to report uninformative earnings to avoid detection of their expropriation activities. Consistent with the agency theory and the above accounting literature review, the major hypothesis in this study proposes on: *There is a positive association between RPTs in Indonesian publicly listed companies and level of EM.*

RESEARCH DESIGN

Sample Selection

The projected sample of this study comprise of a sub-sample of 50 companies with equal proportion from manufacturing[12] and non-manufacturing industry[13]. The main criterion for selecting companies in the sample of this study was that they are listed on JSX[14] for two consecutive years of 2004 and 2005 and disclosed RPTs in their annual reports and notes to financial statements. The stratified random sample is drawn from a mixture of companies from all types of industries. However, consistent with past studies, financial institutions (banks, insurance, unit trusts and finance firms) are excluded due to the nature of regulation and fundamental differences in the accrual generating process. A total of 100 annual reports[15] are collected and analysed. Prior empirical studies have also used annual reports in the investigation of RPTs and EM issues (Jian and Wong, 2004; Kohlbeck and Mayhew, 2004; Aharony, et al., 2005; Gordon and Henry, 2005). The data collected for the purpose of analysis are in Indonesian currency (IDR) to provide more accurate and comparable information than otherwise might be due to the differences of exchange rates conversion.

Proxy for Earnings Management and Related Party Transactions

Prior to estimating discretionary accruals, total accruals (TAC) are calculated as:

$$TAC_{jt} = (\Delta CA_{jt} - \Delta Cash_{jt}) - (\Delta CL_{jt} - \Delta LTD_{jt} - \Delta ITP_{jt}) - DPA_{jt}$$

Where:

TAC_{jt} = total accruals for firm j in time period t

ΔCA_{jt} = change current assets for firm j from time period t-1 to t

$\Delta Cash_{jt}$ = change cash balance for firm j from time period t-1 to t

ΔCL_{jt} = change current liabilities for firm j from time period t-1 to t

ΔLTD_{jt} = change long-term debt included in current liabilities for firm j from time period t-1 to t

ΔITP_{jt} = change income tax payable for firm j from time period t-1 to t

DPA_{jt} = depreciation and amortisation expense for firm j from time period to t.

TAC then is decomposed into normal accruals (*NAC*) and discretionary accruals (*DAC*) using the cross-sectional *modified* Jones (1991) model defined formally as:

$$\begin{aligned} \mathrm{TAC}_{jk,t} / \mathrm{TA}_{jk,t-1} &= \alpha_{jt} \left[1 / \mathrm{TA}_{jk,t-1}\right] \\ &+ \beta_{jt} \left[(\Delta\Delta \mathrm{RE}_{jk,t} - \Delta \mathrm{REC}_{jk,t}) / \mathrm{TA}_{jk,t-1}\right] \\ &+ \gamma_{j,t} \left[\mathrm{PPE}_{jk,t} / \mathrm{TA}_{jk,t-1}\right] + \varepsilon_{jk,t} \quad \text{.....(2)} \end{aligned}$$

Where:

$\mathrm{TAC}_{jk,t}$ = total accruals for firm j in industry k in year t

$\mathrm{TA}_{jk,t\text{-}1}$ = are total assets for firm j in industry k at the end of year t-1

$\Delta\mathrm{REV}_{jk,t}$ = change net sales for firm j in industry k between years t-1 and t

$\Delta\mathrm{REC}_{jk,t}$ = change in receivables for firm j in industry k between years t-1 and t

$\mathrm{PPE}_{jk,t}$ = gross property, plant and equipment for firm j in industry k in the year t

α_j, β_j, γ_j = industry specific estimated coefficients

ε_j = error term.

NAC is defined as the fitted values from Eq. 2 whilst DAC is the residual (TAC minus NAC). Schipper (1989) and Aharony *et al.*(2005) classify RPTs as real means of EM (timing investment or financing decision to alter reported earnings). RPTs include items such as sales and purchases of product and materials, borrowing and lending, interests, rents, purchase and sales commissions, and exchange of fixed assets. Gordon *et al.*(2004) measures RP in term of the parties, type of transactions, and transaction dollar amount. In their research, Jian and Wong (2004) utilise RP sales for it recurring nature (determine normality and abnormality level of RPTs) and RP purchases in the sensitivity analysis. Kohlbeck and Mayhew (2004) analyse the types and nature of RPTs (simple and complex). On the other hand, Aharony *et al.*(2005) uses changes of sales of goods and services and changes of net credit in their study. Furthermore, Gordon and Henry (2005) draw on the total number of different RPTs, RPTs by different parties, the amount disclosed and the complexity. The more recent study conducted by Cheng and Chen (2007) tests the association between EM and RPTs with operating RPTs (non-loan) and loan RPTs. There are different measurements utilised in previous empirical research. In the main analysis of this study, the absolute amounts of RPTs in IDR in the annual reports are used. Alternative measures of RPTs such as number of types of RPTs and RP sales are utilised in additional sensitivity analysis.

Control Variables Proxies

In the regression, some variables are included to control for other factors found to be associated with EM. Similar with previous research (Dechow, 1994; Klein, 2002; Jian and Wong, 2004; Gordon and Henry, 2005; Rusmin, 2006) several control variables is introduced, such as Cash Flow from Operation (CFO), Leverage, Return on Assets (ROA), Firm Size and Big-4 audit firms (BIG-4). Gordon and Henry (2005) similar with Aharony *et al.*(2005) used operating cash flow (CFO) as an indicator variable for negative earnings to control for other properties of earnings and accruals. Dechow (1994) and Kasznik (1999) propose that accruals are negatively correlated with operating cash flow. Thus a control variable of CFO is incorporated to control for discretionary accruals correlation with operating cash flow. DeFond and Jiambalvo (1994) find that that leverage is positively associated with EM. Leverage ratio is incorporated as a control variable since this variable may in part capture the value of corporate tax shield (Jian and Wong, 2004). Previous research (Dechow, et al., 1995; Frankel, et al., 2002) report that DAC is also dependent on a firm's financial performance because it may affect corporate management's opportunistic window and incentives for managing earnings (Krishnan, 2003). In addition, McNichols (2000) argues that accruals, estimated nondiscretionary accruals and discretionary accruals are significantly positively correlated with ROA. Therefore, this study utilises ROA as one of the control variables. In addition, firm size has been used in previous studies as a control for firm's growth opportunities. Gordon and Henry (2005) suggest that size is included as control variable because political costs are negatively associated with EM. The final control variable included is Big-4 audit firms. Prior research usually distinguishes between non Big-4 and Big-4 audit firms arguing the latter to be of a higher quality than the former (Mayhew and Wilkins, 2003). Proxy measures for dependent, independent and control variables are defined in Table 1.

Table 1: Variables Definition and Description

Variables Title	Variable Description
Dependent Variable Absolute DAC	Absolute DAC's firm *i* for year *t* measured by modified Jones (1991) model
Independent Variable Lagged total amounts of RPTs	Absolute value of total RPTs divided by total assets for firm *i* for year *t-1*
Control Variables Cash Flow (CFO)	Cash flow from operations for firm *i* during the year t deflated by total assets as at end of year *t-1*
Leverage	Ratio of book value of total liabilities of firm *i* for year t to book value of total assets of firm *i* for year *t*
Return on Asset (ROA)	Ratio of net income of firm *i* for year t to book value of total assets of firm *i* for year *t*
Firm Size	Natural logarithm of total book value of assets of firm *i* for year *t*
Big-4 Audit Firms (BIG-4)	Indicator variable with firm *i* scored one (1) if their incumbent auditor in fiscal year *t* is a Big-4 firm; otherwise scored zero (0)

Empirical Model Equation

This study uses Ordinary Least Square multiple regression as the main statistical technique to test the hypothesis. The main regression model is defined in the following equation:

$$DAC_{i,t} = b_0 + b_1 RPTs_{i,t} + b_2 CFO_{i,t} + b_3 Leverage_{i,t} + b_4 ROA_{i,t} + b_5 Firm\ Size_{i,t} + b_6 BIG\text{-}4_{i,t} + e_{i,t}.$$

Where:

DAC = estimated discretionary accruals calculated by the modified Jones (1991) model

RPTs = firm *i*'s absolute value of total RPTs divided by total assets for firm *i* for year *t-1*

CFO = cash flow from operation scaled by total assets

Leverage = firm *i*'s total liabilities divided by total assets

ROA = ratio of net income of firm *i* for year t to book value of total assets of firm *i* for year *t*

Firm Size = natural logarithm of total assets at year end *t*

b_i = regression coefficients

e = regression residual or error term

i = company indicator.

RESULTS

Descriptive Statistics

Gordon and Henry (2005) identified seven main types of RPTs such as direct services, purchases of goods or contract services, sales to related parties, loans to related parties, fixed-rate financing from related parties, investments and other. According to PSAK No.7, firms should disclose the nature of the relationships, the RPTs[16], as well as information about the transactions and outstanding balances necessary for understanding potential effect of the relationship on the financial statements (Indonesian Institute of Accountants, 1994).

Similar to past research, the RPTs disclosed in the study sample data are quite diverse. For the purpose of descriptive analysis, total values of RPTs are modified in several ways. Firstly, the values of all RPTs are aggregated (total amount of RPTs)[17]. Then, the RPTs are categorized into the class of the transactions as appear in balance sheet and profit and loss statements[18]. Furthermore, only the major recurring RPTs are analysed. Table 2 presents the basic descriptive statistics from 100 observations and broken down by industry type (manufacturing and non-manufacturing) and financial period (period ended 2005 and 2004).

Table 2: Descriptive Statistics of RPTs

VARIABLE DESCRIPTION	MEAN	MEDIAN	STD DEVIATION	MIN	MAX	AVERAGE (%)
Total amount of RPTs	523,569,398	59,307,737	1,227,592,820	135,399	7,652,218,000	
Manufacturing	371,647,264	82,651,218	582,312,384	135,399	2,462,976,419	
Non-manufacturing	675,491,533	55,696,615	1,630,500,723	793,604	7,652,218,000	
Year ended 2005	557,616,863	64,938,747	1,252,079,292	135,399	7,149,399,000	
Year ended 2004	489,521,934	59,307,737	1,214,353,621	812,083	7,652,218,000	
All financial statements accounts						
Total assets	139,747,947	14,439,104	506,902,260	0	3,539,082,000	41.46%
Manufacturing	54,507,014	25,996,778	65,999,787	0	260,535,536	
Non-manufacturing	224,988,881	13,718,219	707,077,860	0	3,539,082,000	
Year ended 2005	148,281,710	14,439,104	524,129,139	0	3,539,082,000	
Year ended 2004	131,214,185	14,928,428	494,250,645	0	3,296,102,000	
Total liabilities	95,239,822	5,034,347	259,582,722	0	1,514,563,000	23.47%
Manufacturing	67,642,379	10,125,202	212,658,252	0	1,482,474,502	
Non-manufacturing	122,837,264	3,962,500	298,937,601	0	1,514,563,000	
Year ended 2005	102,559,136	5,627,016	276,858,961	0	1,482,474,502	
Year ended 2004	87,920,507	4,832,286	243,682,848	0	1,514,563,000	
Total revenues	109,776,706	1,990,446	268,241,202	0	1,701,621,000	19.82%
Manufacturing	141,230,330	12,621,831	230,886,814	0	947,607,669	
Non-manufacturing	78,323,082	103,500	300,078,919	0	1,701,621,000	
Year ended 2005	119,007,472	1,978,174	268,760,687	0	1,312,829,000	
Year ended 2004	100,545,940	2,115,895	270,127,602	0	1,701,621,000	
Total expenses	178,804,923	150,000	540,304,573	0	3,695,644,843	15.25%
Manufacturing	108,267,542	112,493	257,592,244	0	1,198,907,301	
Non-manufacturing	249,342,305	1,001,518	716,455,098	0	3,695,644,843	
Year ended 2005	187,768,544	159,404	584,449,729	0	3,695,644,843	
Year ended 2004	169,841,303	127,766	498,066,602	0	2,975,608,590	
Total (%tage)						100.00%

Legend: Data of RPTs are in thousands of IDR. Total amount of RPTs is the aggregate amounts of all related parties transactions disclosed by sample firms. This amount is further sub classified as assets, liabilities, revenues and expenses. All values are in thousands of IDR. Average percentage from total amount is the proportion of each sub class of RPTs amount as a percentage of total RPTs amount.

As presented in Table 2, average total amount of RPTs from the 100 observations is 523,569,398 thousands IDR. The average total amounts for manufacturing firms is considerably lower than that of non-manufacturing firms. This amount accounted approximately half as much as total RPTs amount of non-manufacturing firm. However, there is only slight increase of 13.91% from 2004 (489,521,934 thousands IDR) to 2005 (557,616,863 thousands IDR). The second part of the Table 2 provides descriptive statistics of RP *assets*, RP *liabilities*, RP *revenues* and RP *expenses*[19]. On average, RP *assets* are 7.81% of company's total assets, RP *liabilities* are 9.24% of company's total liabilities and RP *revenues* are 8.70% of company's net sales. In addition, the averages value of both total RP *assets* (54,507,014 thousands IDR) and RP *liabilities* (67,642,379 thousands IDR) are lower for manufacturing firms. Non-manufacturing firms' total RP *assets* and total RP *liabilities* are correspondingly 75.77% and 44.93% higher. However, manufacturing firms' revenues from related parties (141,230,330 thousands IDR) account twice as much as those of non-manufacturing firms (78,323,082 thousands IDR). Furthermore, the

results from the descriptive statistics suggest that RP *assets* transactions on average made up approximately 41.46% of the total amount of RPTs. This transaction is the highest in value followed by RP *liabilities* transaction (23%.47), RP *revenues* transaction (19.82%) and RP *expenses* transaction (15.25%). There are limited studies on EM and these studies utilise different measure of RPTs. There is no known prior study that classifies RPTs into assets, liabilities, revenue and expenses for the purpose of descriptive. The results are thus not comparable. However, the results from descriptive statistics might suggest that Indonesian firms provide more RP lending than RP borrowing (RP *assets* greater than RP *liabilities*). Table 3 presents the basic descriptive statistics for the major accounts for 100 observations and the specification by financial period[20].

The accounts receivables and due from related parties on average accounted 10.31% and 12.26% respectively from 41.46% of total RP asset transactions. The remaining of this proportion is other assets[21] of 18.89%. On average, the RP *liabilities* transaction is 23.47% of the total amount of RPTs. This 23.47% can be traced to approximately 5.12% of RP accounts payable transactions and 9.66% of due to related parties. Other liabilities[22] accounted 8.69% of total amount of RPTs. On average, other expenses[23] and other revenues accounted 3.44% and 1.55 % respectively.

Table 3: RPTs Classified by Major Accounts[24]

VARIABLE DESCRIPTION	MEAN	MEDIAN	STD DEVIATION	MAX	AVERAGE % FROM TOTAL AMOUNT
ASSETS					
Accounts receivable	26,784,887	3,251,217	54,018,983	322,669,000	10.31%
Year ended 2005	29,841,598	3,088,490	55,838,862	260,535,536	
Year ended 2004	23,728,175	3,251,217	52,522,436	322,669,000	
Due from RP	24,157,712	951,453	109,503,214	794,518,634	12.26%
Year ended 2005	24,150,152	776,468	112,565,075	794,518,634	
Year ended 2004	24,165,271	1,249,904	107,497,557	759,543,611	
Other assets	88,805,349	681,729	445,301,452	3,332,282,000	18.89%
LIABILITIES					
Accounts payables	28,655,810	38,887	85,448,468	550,152,384	5.12%
Year ended 2005	29,024,994	187,516	88,451,250	550,152,384	
Year ended 2004	28,286,625	22,000	83,234,539	490,867,794	
Due to RP	8,100,049	59,703	27,153,073	177,616,017	9.66%
Year ended 2005	3,424,498	0	8,736,763	53,438,043	
Year ended 2004	12,775,599	180,713	36,995,684	177,616,017	
Other liabilities	58,483,963	0	245,727,211	1,474,500,000	8.69%
REVENUES					
Sales to RP	108,369,928	667,653	265,987,904	1,739,965,000	18.27%
Year ended 2005	115,831,499	848,200	259,451,431	1,242,222,000	
Year ended 2004	100,908,357	397,721	274,798,710	1,739,965,000	
Other sales	1,406,809	0	10,647,516	70,607,000	1.55%
EXPENSES					
Purchases from RP	151,413,336	0	521,387,952	3,692,233,334	11.81%
Year ended 2005	159,303,766	0	566,181,078	3,692,233,334	
Year ended 2004	143,522,907	0	478,069,644	2,972,197,081	
Other expenses	27,391,587	0	164,860,002	1,205,993,000	3.44%
TOTAL (%TAGE)					100.00%

Legend: Total asset can be further traced to RP accounts receivables transactions and due from related parties. Total liabilities can be further traced to RP accounts payables transactions and due to related parties. The major account that constitutes revenue is sales revenue from goods and services to related parties. The major account that constitutes expenses is purchases of raw materials from related parties. Average percentage from total amount is the proportion of each class of RPTs amount as a percentage of total RPTs amount.

This study finds that on average, sales to RP alone accounted 18.27% of the total amount of RPTs disclosed by companies. Descriptive statistics results suggest that sales to RP is higher than purchase from RP (11.81%). The finding is different from those of past studies on IPO firms (Jian and Wong, 2004; Aharony et al., 2005) which suggest that RP sales[25] are lower than RP purchases. However, their studies focus on IPO period that might induce tunneling[26] behaviour from IPO firms to parent companies post-IPO, while this study focuses on non-IPO period. Interestingly, this study is in line with past studies (Jian and Wong, 2004; Aharony, et al., 2005) in term of higher RP receivables (accounts receivable and due from RP) of 22.57% compared to RP payables (accounts payable and due to RP) of 14.78%. Following the suggestions by Jian and Wong (2004), there are two possible explanations of this result. The first explanation is that firms may have more assurance in the collection of credit provided based on the stable and long-term relationships developed among group members, thus offer larger amounts of credit to affiliated firms. The other possible explanation is that credit offering can be employed as a tool for tunneling by lending more and borrowing less from RP. However, it is beyond the scope of this study to investigate tunneling behaviour of Indonesian firms and this issue may be an interesting topic for future research.

Gordon and Henry (2005) argue that the more parties and more types of RPTs indicate extensive and pervasive potential conflicts of interest and monitoring issues implied by agency theory. The number of different types of RPTs disclosed ranges from 1 to 21. On average, these Indonesian firms have 5.51 out of all different types with a median of 5 and standard deviation of 3.75. This result is higher compared to other study, Gordon and Henry (2005) find that on average, U.S. companies have 2.19 RPTs types with a median of 2 and standard deviation of 1.71 out of the 18 different types they identified[27]. The differences might be the result of different sample data utilised, developed economies (U.S. firms) relative to developing economies (Indonesian firms). Furthermore, variation in the way of classifying types of RPTs may influence the comparability of the results. Table 4 presents the descriptive statistics for the study's dependent and control variables.

As shown in this table, the average discretionary accruals (DAC) are 11.78% of total assets at the beginning of the year. The value is far higher when compared to the average DAC reported in Australia of -0.9% (Rusmin, 2006). Furthermore, this average also differs when compared to other Asian countries like Singapore (2.69% of total assets) (Rusmin, 2006) and (7.9% of total assets)[28] China (Cheng and Chen, 2007). The higher mean DAC is consistent with recent international comparative study by Leuz, et al.(2003) which suggests that EM is more pervasive in newly developed and emerging countries with relatively concentrated ownership, weak investor protection and less developed stock market. The distribution of absolute DAC is quite varied. The number of firms having positive and negative DAC is almost equal with 45 firms and 55 firms respectively. This approximately equal proportion of observations with positive and negative DAC is consistent with other research (Klein, 2002; Rusmin, 2006; Rusmin, et al., 2006). The almost equal proportions thus do not provide evidence of systematic upward or downward earnings management activity. It is likely that the sample data is relatively random with respect to earnings management incentives (Healy and Wahlen, 1999; Klein, 2002).

The average DAC in 2004 (8.82%) is lower than that of 2005 (14.73%). T-test results suggest that there is significant difference of mean DAC between these two periods ($p<0.05$). The changes of the DAC of Indonesian firms are in similar direction with the changes of ROA. Average firms' ROA is higher for period ended 2005 (7.76%) compared to those for the period ended 2004 (5.75%). Kaznik (1999) argues that DAC estimates are correlated with earnings performance. Moreover, McNichols (2000) also proposes that DAC estimates are significantly

positively associated with ROA. The DAC between manufacturing firms and non manufacturing firms also differ significantly (t-test, $p<0.01$)[29] with 17.24% of total assets and 6.31% of total assets respectively. Descriptive statistics results suggest that the average size of non-manufacturing firm are considerably greater than manufacturing firms. The plausible explanation is that larger firms are subject to more extensive political scrutiny compared to smaller firms (Watts and Zimmerman, 1990) thus reduces the ability to manage earnings using DAC[30]. In addition, perhaps the regulatory environment and accounting regulations might be different which allows greater use of DAC by manufacturing firms.

Table 4: Dependent and Control Variables' Descriptive Statistics

VARIABLE DESCRIPTION	MEAN	MEDIAN	STD DEVIATION	MIN	MAX
Dependent variable					
Absolute DAC	0.1178	0.0762	0.1449	0.0014	0.8499
Manufacturing	0.1724	0.1146	0.1853	0.0060	0.8499
Non-manufacturing	0.0631	0.0587	0.0448	0.0014	0.1965
Year ended 2005	0.1473	0.0869	0.1760	0.0014	0.8499
Year ended 2004	0.0882	0.0707	0.0983	0.0020	0.6089
Positive DAC (%)	45%				
Negative DAC (%)	55%				
Control Variables					
Firm Size	1,789,407,453	559,630,076	4,517,398,266	35,583,366	32,787,133,000
Manufacturing	1,086,393,454	460,939,560	1,958,676,817	73,907,068	10,536,379,744
Non-manufacturing	2,492,421,452	660,973,502	6,032,014,293	35,583,366	32,787,133,000
Year ended 2005	1,940,161,939	585,220,840	4,904,056,221	61,347,659	32,787,133,000
Year ended 2004	1,638,652,967	518,227,015	4,139,334,776	35,583,366	27,872,467,000
Leverage	0.5787	0.5409	0.3533	0.0449	2.2409
Manufacturing	0.6465	0.5440	0.4552	0.0475	2.2409
Non-manufacturing	0.5109	0.5409	0.1886	0.0449	0.8254
Year ended 2005	0.5587	0.5409	0.3416	0.0449	2.2409
year ended 2004	0.5987	0.5392	0.3669	0.0596	2.1848
ROA	0.0676	0.0646	0.0963	-0.2791	0.4049
Manufacturing	0.0617	0.0392	0.1179	-0.2791	0.4049
Non-manufacturing	0.0735	0.0686	0.0691	-0.0919	0.2105
Year ended 2005	0.0776	0.0680	0.0782	-0.0519	0.3856
Year ended 2004	0.0575	0.0424	0.1114	-0.2791	0.4049
CFO	0.0474	0.0477	0.1202	-0.3855	0.3537
Manufacturing	0.0377	0.0327	0.0996	-0.2489	0.2766
Non-manufacturing	0.0571	0.0643	0.1382	-0.3855	0.3537
Year ended 2005	0.0559	0.0625	0.1196	-0.3855	0.3007
Year ended 2004	0.0389	0.0288	0.1215	-0.2508	0.3537
Auditor type (%)					
Big-4	35%				
Non Big-4	65%				

Legend: Absolute DAC are the absolute value of DAC determined using Modified Jones (1991) Model. Positive (Negative) DAC and Big-4 (Non Big-4) are dichotomous variables. Firm Size: firm *i* firm's total assets in year t. Leverage: firm *i* total liabilities in year t scaled by total asset in year t. ROA: firm *i* net income in year t divided by total assets in year t. CFO: ratio of firm *i* CFO in year t scaled by total asset in year t-1. Auditor: Big-4 auditors are PWC, EY, KPMG and DT.

As listed in Table 4, the five control variables utilised in the analysis are Firm Size, Leverage, ROA, CFO and Big-4 audit firms. Table 4 indicates that the average firm size (measured by the total asset) is 1.789.407.453 thousands IDR. Average leverage in Indone-

sian firms is around 57.87 %. This is higher than those of Australian firms of 44.8% (Davidson, et al., 2005) and those of seven East Asian economies of 46.83% (Fan and Wong, 2002). This high leverage level in Indonesia is consistent with the past study conducted by the Central Bank of Chile (2004) that suggests that Indonesia is one the highest leveraged Asian countries with 35.3% debt-to-equity ratio. Chavalier, et al.(2006) propose that the high leverage is facilitated by the related-bank credit behaviour in Indonesia where firms can easily access short-term borrowing without enough collateral and some business group (conglomerates) were allowed to establish their own commercial banks to serve the needs of other corporations within the group.

As reported in Table 4, average ROA is 6.76% (7.76% for period ended 2005 and 5.75% for the period ended 2004). The average ROA is higher than the ROA of another Indonesian study (2.00%) conducted by Nurhayati, et al.(2006)[31]. The difference might be a result of Indonesia is ongoing recovery from the effects of economic crisis that hit the country in mid 1997. In addition, the ROA figure is slightly higher than the average ROA from a similar study of Chinese firms of 5.73% (Jian and Wong, 2004). Furthermore, the distribution of the Big-4 and non Big-4 auditor in sample companies are 35 % and 65%[32] respectively. This percentage is quite low compared to Rusmin et al. (2006) study of Singaporean firms which indicate that 86.57% of the sample data is audited by Big-4 audit firms. Results of chi-square goodness of fit test suggest that the choice of Big-4 and non Big-4 auditors are not uniformly distributed ($p<0.01$). The lower percentage for Big-4 auditors could reflect the point that Indonesian market could be different from developed markets such as U.S. and Australia. There are 156 accounting firms registered with BAPEPAM at June 2001 consists of Big-5[33] audit firms, 20 affiliates of other international firms and 131 local audit firms (Tas-Anvaripour and Reid, 2002). In Indonesia, local audit firms might have established their market share and have a good relationship with local firms. In addition, despite the fact that Big-4 audit firms have numerous international clients, local audit firms might be better in offering more localised services with better insights into local trends and regulatory issues.[34] The last control variable is CFO with an average of 4.7% with non manufacturing firm's CFO (5.71%) slightly higher than that of manufacturing firms (3.77%). However, independent sample t-test results suggest that there is no significant difference (t-test, $p>0.10$) of CFO between manufacturing and non-manufacturing firms.

Correlation Matrix

Table 5 presents a correlation matrix between the dependent, independent and control variables. The upper half of the each panel reports Pearson pairwise correlation coefficients (cr_p), whereas the lower half is Spearman correlation coefficients (cr_s). Correlation results do not support the hypothesis. Although, the absolute DAC is negatively correlated with the total amount of RPTs, the correlation is not significant. In regard to correlations between independent and control variables, and amongst control variables themselves, significant correlations are reported in the correlation matrix. The highest correlation is between the ROA and CFO, with a correlation of 0.425. All the value of the significant correlation are below the critical limit of 0.80 (Cooper and Schindler, 2003), suggesting any multicollinearity problem between the variables is not a serious concern in the model estimation.

Univariate Results

This section outlines the univariate analysis between the DAC with various types of RPTs and between DAC with the control variables. Table 6 reports the independent sample t-test results[35] between absolute DAC and the control variables.

Table 5: Pearson and Spearman Correlation Matrix

	DAC	LAGGED TOTAL AMOUNT	FIRM SIZE	LEVERAGE	ROA	BIG-4	CFO
DAC		-0.031	0.040	-0.024	0.052	0.010	-0.033
Lagged RPTs	-0.057		0.034	0.082	0.047	-0.032	-0.173
Firm Size	-0.002	0.101		0.153	0.080	0.232**	0.183
Leverage	-0.044	0.220**	0.291*		-0.282*	0.108	-0.196
ROA	-0.075	0.241**	0.205**	-0.152		0.187	0.316*
BIG-4	-0.074	-0.004	0.289*	0.184	0.269*		0.197**
CFO	-0.045	0.044	0.159	-0.297*	0.425*	0.222**	

Legend: *, ** and *** indicate significance at p<0.01, p<0.05 and p<0.10 respectively (based on two tailed tests).

Table 6: Independent Sample T-test of DAC with Control Variables

	N	MEAN ABSOLUTE DAC	MEAN DIFFERENCE	T-STATS (TWO-TAILED)	MANN-WHITNEY U SIG. (TWO-TAILED)
Industry types					
Manufacturing	50	0.1724	0.1092	**0.0000***	**0.0000***
Non-manufacturing	50	0.0631			
Audit firm					
Big-4	35	0.1197	-0.0030	0.9210	0.4630
Non Big-4	65	0.1167			
Firm size					
Large	50	0.1255	-0.0155	0.5960	0.9780
Small	50	0.1100			
Firm Profitability					
Positive ROA	81	0.1236	-0.0351	0.4110	0.8500
Negative ROA	19	0.0930			

Legend: *, ** and *** indicate significance at p<0.01, p <0.05 and p<0.10 respectively (based on two tailed tests). The results are consistent with Mann-Whitney U non parametric test. *Industry type*: firm *i* is defined as manufacturing if manufacturing firms; otherwise defined as non-manufacturing. *Audit firm*: firm *i* is defined as Big-4 if it incumbent auditor is either PWC, KPMG, EY or DT; otherwise defined as non Big-4. *Firm Size*: firm *i* is defined as large if it has above median value of logarithm total assets (20.1426) for the 100 observations; otherwise defined as small firm. *Firm Profitability:* firm *i* is defined as positive ROA if the ROA is positive; otherwise defined as negative ROA.

Prior research suggests some specific characteristics might influence the magnitude of EM. The results suggest that there is significant difference (p<0.01) of mean values of DAC on manufacturing and non manufacturing firms. This finding is consistent with previous studies on Australian data (Godfrey and Koh, 1998; Rusmin, 2006) who find that the mean absolute DAC is higher for manufacturing firm. Several studies (Krishnan, 2003; Francis, et al., 2005) suggest that Big-4 auditors have better quality than non Big-4 auditors and clients of Big-4 audit firms on average report lower DAC than those of non Big-4 clients. However, the result of independent sample t-test in Table 6 suggests that there is no difference in mean DAC between Big-4 and non Big-4 audited firms. Watts and Zim-

merman (1990) propose that large firms manage their earnings down more actively to minimise political scrutiny. However, the findings in this study are consistent with previous research by Reynolds and Francis (2001) and Chung and Kallapur (2003), t-test results suggests that there is no significant difference in means between large and small firms. Unlike Rusmin (2006) results using Australian data, the t-test result in Table 6 suggests that there is no significant difference in mean DAC between poor performing companies (Negative ROA) and good performing companies (Positive ROA).

Table 7 provides the results of independent sample t-test between absolute DAC and various types of RPTs. The t-test results between RP asset accounts (accounts receivables and due from related parties), RP purchases and RP net asset[36] accounts with DAC indicate that there is no significant mean difference. However, both RP liabilities transactions (accounts payables and due to related parties) suggest a highly significant mean differences ($p<0.05$). On the contrary to t-test results, Mann-Whitney U tests indicate that there is significance ($p<0.1$) mean difference between DAC and Sales to RP.

Table 7: Independent Sample T-test of DAC with Major RPTs

	N	MEAN ABSOLUTE DAC	MEAN DIFFERENCE	T-STATS (TWO-TAILED)	MANN-WHITNEY U SIG. (TWO-TAILED)
Accounts receivables					
No account receivables	26	0.1251	0.0099	0.7650	0.9250
With account receivables	74	0.1152			
Due from RP					
No due from RP	41	0.1438	0.0441	0.1770	0.3490
With due from RP	59	0.0997			
Accounts payables					
No account payables	48	0.1567	0.0748	**0.0120***	**0.0120***
With account payables	52	0.0818			
Due to RP					
No due to RP	50	0.1575	0.0795	**0.0060***	**0.0580***
With due to RP	50	0.0780			
Sales					
No sales to RP	44	0.1050	-0.2281	0.4370	**0.1870***
With sales to RP	56	0.1278			
Purchases					
No purchases from RP	58	0.1339	0.0384	0.1930	0.3490
With purchases from RP	42	0.0955			
RP Net Asset					
Positive RP net asset	63	0.1281	-0.0280	0.2670	0.4690
Negative RP net asset	37	0.1001			

Legend: *, ** and *** indicate significance at $p<0.01$, $p<0.05$ and $p<0.10$ respectively (two tailed tests). The results are consistent with Mann-Whitney U non parametric test. *Accounts receivable, due from related parties, accounts payables, due to related parties, sales, and purchase:* firm *i* is defined as no such transaction if there is no such related parties transactions disclosed in annual reports; otherwise defined as with each transactions. *RP Net asset:* firm *i* is defined as positive RP Net asset firm if the disclosed RP total assets exceed RP total liabilities; otherwise defined as negative RP Net asset.

Multivariate Main Results

Table 8: Multiple Regression Results[37]

MODEL SUMMARY			
R-square		0.111	
Adjusted R-square		0.047	
ANOVA sig. value		0.121	
Coefficients	**Beta**	**t-statistics**	**sig.**
Constant		1.582	0.117
Lagged total amount of RPTs	-0.013	-0.123	0.902
Firm Size	-0.038	-0.346	0.730
Leverage	-0.247	-2.209	0.300
ROA	-0.134	-1.198	0.234
Big-4	-0.148	-1.345	0.182
CFO	0.113	0.964	0.338

Legend: *, ** and *** indicate significance at p<0.01, p<0.05 and p<0.10 respectively (based on two tailed tests). Refer to Table 3.3 for full definition and descriptions of the dependent, independent and control variables. Lagged total amount of RPTs: total amount of RPTs scaled by total assets year t-1.

A total of 50 companies for two years (100 observations) are included in this regression. The main results for testing the hypothesis are reported in Table 8. The initial regression shows that only 11.10% of the variation of absolute DAC is explained by the independent variable and control variables. The ANOVA significant value (0.121) shows that the overall model is not significant. Furthermore, the p-values indicate that the independent variables and control variables are not a significant predictor of EM in Indonesian publicly listed companies. Thus, the result suggests that total amount of RPTs in firms is not a significant predictor of the existence of EM measured by absolute DAC. This finding is contrary to the expectations formed based on review of past literature that suggest RPTs raising the issues of agency conflict of interest (Jensen and Meckling, 1976), represent potential expropriation of the firm's resources (Gordon and Henry, 2005), and alter the reliability of financial statements (Kohlbeck and Mayhew, 2004). In addition, the results do not provide support for the view of RPTs as conflict of interest between managers or board members and shareholders proposed by Gordon *et al.*(2004). All the control variables are statistically insignificant in the multiple regression analysis.

Multivariate Results for Partitioned Subsamples

This section discusses multiple regression analysis for partitioned sub-samples based on DAC sign, firm size and industry type. Past studies (Frankel, et al., 2002; Chung and Kallapur, 2003) suggest that income-incentives may produce different EM behaviour. In addition, other studies (Reynolds and Francis, 2001; Rusmin, 2006) suggest that firm size may influence the magnitude of EM. Moreover, we also analyse the sub-samples of manufacturing and non-manufacturing firms due to the mean absolute DAC of those subgroups are significantly different (t-test, p<0.01). The multiple regression results for the sub-samples (for brevity, the regression table is not included) are similar with those of the initial regression.

Additional Sensitivity and Robustness Checks

We perform additional sensitivity and robustness checks to further ensure the inferences drawn thus far are valid. First, despite the fact that modified Jones (1991) model is a widely accepted model and perhaps the best alternative currently available to test for EM, the model is not free from criticism. To address this concern, sensitivity analysis use alternative models (e.g. cross-sectional variation

of modified Jones (1991) with the ROA and CFO and original Jones (1991) model). Second, past related studies utilise different measures of RPTs. Aharony, et al.(2005) use the changes of sales of goods and services and changes of net credit to measure RPTs. On the other hand, Jian and Wong (2004) use RP sales transactions and RP purchase transactions. This study therefore applies two alternative measures of RPTs. Gordon and Henry (2005) suggests that the more parties and types of transactions indicate extensive and pervasive potential conflicts of interest and monitoring issues. Thus, the first alternative uses the number of types of transactions disclosed by firms. The second alternative is consistent with Jian and Wong (2004) that use RP sales transaction because it is the most significant recurring transactions that have direct impact on EM. All findings from use of alternative measures of EM and RPTs do not facilitate any significant qualitative change in results as reported in Table 8.

DISCUSSION AND CONCLUDING REMARKS

Based on the results of all analyses conducted, this study generally finds no empirical evidence on the existence of relationship between RPTs and EM in Indonesian companies. The results of this study are different from majority of past studies (Jian and Wong, 2004; Aharony, et al., 2005; Cheng and Chen, 2007) in term of the absence of empirical evidence to suggest that RPTs is associated with EM.

There are several feasible reasons for the contradiction with agency theory tenets and insignificant relationship between RPTs and EM in Indonesian context as found in this study. The first reason may be consistent with the alternative views on RPTs, contracting theory suggesting that RPTs can be part of efficient contracting with related parties (Kohlbeck and Mayhew, 2004). This view is supported by Gordon and Henry (2005) who argue that RPTs rationally fulfil other economic demands (such as the need for in-depth company knowledge or expertise) of a company and serve as a mechanism that bond the party to the company. Consequently, it decreases the incentives to engage in risk taking behaviour such as EM that might jeopardise the relationship with the company.

In addition, unique characteristics of Indonesian capital market which is characterised by majority of group-affiliate firms that involve in RPTs can provide further rationalization for this finding. Despite the empirical evidence to date on the benefits and costs of group-affiliation is mixed and far from conclusive, several past studies have documented benefits associated with group-affiliated firms. Past literature suggest that group structure provide benefits for members through sharing intangible and financial resources with other member firms (Chang and Hong, 2000); facilitate development and provide an organisational structure that is better suited to dealing with the poor availability of basic inputs and services (Fishman and Khanna, 1998); or constitute an efficient economic organisations that minimise the transactions costs from coming from the market inefficiencies prevalent in developing countries (Chang and Choi, 1988; Khanna and Palepu, 1997). In addition, Chang and Choi (1988) similar to Khanna and Palepu (1997) also contend that business group replace poorly performing or non existence economic institutions (such as banks or external labour market) that are taken for granted in developed countries. Succinctly, this study in line with past studies (Chang and Choi, 1988; Khanna and Palepu, 1997; Fishman and Khanna, 1998; Chang and Hong, 2000) suggests that the existence of RPTs does not necessarily indicate that companies engage in extensive EM; there is not a clear linkage.

Moreover, RPTs have been under regulator and media intense scrutiny following recent spectacular corporate collapses that manage earnings with RPTs such as Enron, Worldcom, and Parmalat (McCahery and Vermeulen, 2005). Consequently, managers might not see that RPTs as areas where they can easily manage earnings.

Findings of this study have several implications for key parties in accounting prac-

tices, such as professional bodies, regulators, corporate governance reformists and shareholders. Firstly, it can be implied that formation of business groups in Indonesia with higher levels of RPTs do not necessarily indicate that companies engage in greater EM. This result is supported by related past studies (Chang and Hong, 2000; Claessens, et al., 2006). Those studies suggest that there may be gains from group-affiliations and RPTs and it is not necessarily inefficient even though these gains are followed by the rise of agency costs. The real concern might be the lack of corporate governance system that would guard against expropriation. Patrick (2002) asserts that Indonesian regulator' challenge is to strengthen laws pertaining to corporate governance and enforcing them.

Several differences in the findings of this study relative to related past studies during the IPO process (Jian and Wong, 2004; Aharony, et al., 2005; Cheng and Chen, 2007) might imply that the company managements' incentives to manage earnings differs during IPO period and non-IPO periods. Perhaps accounting standard setters should consider additional accounting regulations to ensure appropriate accounting practices are conducted during the IPO process.

Similar with two alternative views on RPTs, there are different views regarding EM practices. Arya, et al.(2003) question the majority view on EM – that it is against the best interest of shareholders. They argue that some accounting research show that income manipulation is not an unmitigated evil; within limits it promotes efficient decisions. This view is supported by Dechow and Skinner (2000) who contend that some EM is expected and should exist in capital markets because of the fundamental need for judgements and estimates to implement accrual accounting. The final implication is that regulators and accounting practitioners are likely to be overstating the concern on EM practices.

Although this study provides useful insights into the extent and association of RPTs and EM in Indonesian publicly listed companies, a number of limitations and suggestions for future research are noted. This study utilises relatively small samples of 50 Indonesian firms (25 manufacturing and 25 non-manufacturing firms) for the period ending 2004 and 2005. A longer term longitudinal study or use of larger samples is recommended, especially given the fact that there are differences between the two years in this study. Furthermore, this study only uses one independent variable (RPTs) and one dependent variable to predict EM behaviour. There might be various characteristics that can be included such as Indonesian ownership structure, corporate governance practices, market valuation of effects, etc. Following past studies (Jian and Wong, 2004; Aharony et al., 2005; Cheng and Chen, 2007), future research can also be conducted on Indonesian IPO firms. In addition, the measurement of RPTs by aggregating several transactions might not be the best measure as, possibly several interesting features can be found by disaggregating this measure. Therefore, future research can be conducted using different measures of RPTs such as the transactions with primary and secondary parties following Gordon and Henry (2005) research design.

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[11] IAS 24 paragraph 9 states that, "A related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged".

[2] Schipper (1989, p. 92) defines EM as, "purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives". This study defines EM as the techniques employed by corporate management to alter earnings numbers to achieve a desired objective within the flexibility of the General Accepted Accounting Practice (GAAP).

[3] Accounting accruals are defined as the difference between reported earnings and cash flow from operation.

[4] Johnson *et al.*(2000) propose that tunneling refers to the observed expropriation of minority shareholders by the controlling shareholders through the transferring of assets and profits out of the controlled firm for the benefit of the controlling shareholders.

[5] The study proposes that controlling owners are perceived to report accounting information for self-interest purposes and limit the information flows to the public, consequently the earnings credibility is weakened because minority shareholders anticipate that the ownership structure gives the controlling owners both the ability and the incentive to manipulate earnings for outright appropriation or to report uninformative earnings to avoid detection of their expropriation activities.

[6] The conclusion drawn by Leuz *et al.*(2003) is based on the sample of 31 countries including Indonesia. They find that Indonesia score relatively high in EM (18.3) compared to those of Australia (4.8) and United States (2.0).

[7] La Porta, Lopez-De-Silanes, and Shleifer (1999) also argues that in countries with poor shareholder protection, firms are typically controlled by family or state and large firms usually have controlling shareholders that have the power and interest to expropriate the minority shareholders.

[8] The General Accounting Office (2003) identified RPTs as one of the nine major reasons requiring companies to restate financial statements (Gordon, Henry, and Palia, 2004).

[9] Jensen and Meckling (1976, p.308) define agency relationship as "a contract under which one or more (principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent".

[10] Despite agency theory is the dominant view adopted in RPTs and EM studies, alternative theory is put forward. Contracting theory (Kohlbeck and Mayhew, 2004) suggest that RPTs can be part of efficient contracting with related parties as a substitute for cash-based or more liquid compensation to officers and directors. In addition, RPTs are used to minimize transaction costs (Jian and Wong, 2004), fulfil other economic demands of a company as well as bonding mechanism to the company (Gordon and Henry, 2005).

[11] The study conducted by Fan and Wong (2002) is based on sample companies of East Asian economies including Indonesia, Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

[12] Manufacturing firms include firms in basic industry and chemicals, miscellaneous industry, consumer goods industry, property and real estate.

[13] Non-manufacturing firms include firms in agriculture, mining, infrastructure, utilities and transportation and trade, services and investments.

[14] JSX is the largest stock exchange in Indonesia with market capitalisation and number of listed companies in year 2005 (2004) of 801 (680) trillion IDR and 336 (331) companies respectively (Jakarta Stock Exchange, 2005).

[15] Indonesian Financial Accounting Standard (PSAK) No.7 in line with IAS 29 requires that firms disclose the RPTs in the notes to financial report (International Accounting Standard Board, 2005).

[16] Examples of transaction between related parties that may need to be disclosed by a reporting enterprise such as purchase or sale of goods, purchase or sale of property and other assets, rendering or receiving of services, transfer of research and development, financing (including providing loan and equity contributions in cash or in kind), guarantees and collateral, and management contracts.

[17] The main regression analysis utilise total amount of RPTs.
[18] The transactions are aggregated into assets, liabilities, revenue or expenses.
[19] There is no related party transaction in equity enclosed in the financial statements of sample companies.
[20] These RP financial statements transactions can be traced further to various types of RPTs. However, for the purpose of analysis only the major and material transactions with high frequency rates that constitute the RP financial statements transactions are presented individually. Other transactions that are rarely disclosed by companies and not material are aggregated in other transactions account.
[21] Other assets consist of other transactions such as cash, other receivables, short-term investments, purchases advances, financelease, etc. Refer to appendix for full list of transactions.
[22] Other liabilities consist of other transactions such as accrued interest, accrued salary and wages, long term loans, etc.
[23] Other expenses consist of transactions such as management fees, administration fees, interest expenses, etc. Refer to appendix for full lists of expenses.
[24] All minimum value of RPTs in Table 4.3 are zero (0).
[25] This studies measure related party transactions as a percentage of total assets.
[26] Johnson *et al.*(2000) propose that tunneling refers to the observed expropriation of minority shareholders by the controlling shareholders through the transferring of assets and profits out of the controlled firm for the benefit of the controlling shareholders.
[27] Gordon and Henry (2005) use different classification for RPTs types.
[28] This value is industry adjusted asset-scaled discretionary accruals (DAC) of the year before IPOs's from 239 Chinese-firms' IPOs.
[29] Refer to section 4.3 for univariate analysis.
[30] Gordon and Henry (2005) suggest that political costs are negatively associated with EM.
[31] The studies conducted by Nurhayati *et al.*(2006) utilise sample of 100 Indonesian companies listed on JSX for the year ending 2003.
[32] Although the observation is 50 companies two years data pooled together, the unequal percentage is due to companies changed auditors during the two-year period.
[33] As at June 2001, Arthur Andersen was still considered Big-5 firm.
[34] In Thailand, there is a case where the local auditors' growth are higher compared to Big-4 audit firms (SCI Double Impact and Audit Plus, 2005).
[35] Additional Mann-Whitney U tests are conducted because the normality assumption of DAC cannot be assumed. The findings of all t-test are consistent with those of Mann-Whitney U test.
[36] The test on net assets is conducted based on the logic that companies might engage in RPT transactions that boost their net assets as a way to manage earnings.
[37] Stepwise regression is conducted to confirm the results of the initial regression. The results of stepwise regression confirm that there are no significant variables in the model.