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Discussion of "Are Related Party Transactions Red Flags?"

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ABSTRACT

Kohlbeck and Mayhew (2017) create a new data set featuring two types of related party transactions. They use empirical-archival methods to investigate the effect of such transactions on the likelihood of restatements and on audit fees. Their findings suggest that related party transactions related to directors, officers and major shareholders are associated with poor "tone at the top" and that this leads management to negotiate for lower quality audits to minimize monitoring costs. To offer avenues for future research, we focus our discussion on three aspects of their paper related to causality, definitions of variables, and generalizability to non-US jurisdictions.

1. Introduction

In their paper, Kohlbeck and Mayhew (2017) (hereafter KM), analyze hand-collected data for listed US S&P 1500 firms for 2001, 2004 and 2007 to demonstrate that certain types of related party transactions (RPTs) are associated with a higher likelihood of financial restatement and, surprisingly, with a lower audit fee.[1] The authors present two main findings.

First, the occurrence of one specific type of related party transaction related to Directors, Officers and major Shareholders (which they label "RPT-DOS") is indicative of an increased likelihood of financial restatement, although the RPT-DOS itself is not the cause of the accounting error which leads to the restatement. The authors find that restatements are associated with characteristics of both the company and auditor. Independent variables in the model include auditor size, company growth rate, net assets and profit level. The variable RPT-DOS remains statistically significant even after the inclusion of proxies for corporate governance in the model. Based on the results of this statistical analysis, the authors make inferences about the reliability of RPT-DOS as an indicator of poor quality accounting. Second, the authors find that firms with simple RPT-DOS are surprisingly associated with lower

[1] See Gordon et al. (2007) for a survey on related party transactions.

audit fees, which they attribute to lower demand for monitoring by management in companies with poor accounting quality.

In terms of methodological choices, the authors sensibly apply standard econometric techniques. One example of a possible refinement might be the use of firm fixed effects, instead of their use of industry fixed effects (Gormley and Matsa, 2014; Amir et al., 2016). Further, propensity score matching is increasingly used (see Shipman, Swanquist, and Whited, 2017). KM carefully acknowledge their choices but the literature still lacks guidance regarding when accurate inferences are derived from non-randomized experiments, with Shadish, Clark, and Steiner (2008) as a notable exception.

The remainder of our discussion suggests three areas in which qualitative research can potentially supplement this empirical archival study. These relate to the interpretation of causality in the study, the definition of the variables included in the model, and cross-cultural applications of the findings.

2. Causality

In the red flag/restatement model, KM find an association between RPT-DOS and financial restatement, which they link to poor "tone at the top". Although this proposal is intuitively reasonable, further field-based research could provide evidence to support the underlying causal mechanisms at work. Qualitative researchers argue that field-based, and even interpretive, research can help enhance our understanding of causal relationships between variables (see Lukka, 2014, Miller and Power, 2013, and Power and Gendron, 2015). When carried out in accordance with strict methodological criteria (Van der Stede, 2014), qualitative research can usefully enhance quantitative models and the specification of models (Chahed and Goh, 2016). In order to identify factors that might indicate the relationship between the presence of RPT-DOS and poor accounting quality, future field-based research could investigate the ex-ante process of authorization of RPTs, the attitude of management to RPTs and the view of managers in firms with RPTs on the value of high quality accounting, thereby illuminating the causal mechanisms at work in the observed association between RPT-DOS and poor accounting quality.

A surprising result of the KH study is the observation that a RPT-DOS is associated with lower audit fee levels. In the literature on auditing, a number of

participant and interview-based studies offer insights into the processes and motivations of those participating in audit practice. These studies reveal the ritualistic nature of audit work (Pentland, 1993), the role of audit committees (Gendron et al., 2004), the effect of corporate governance regulation on staff retention issues within audit firms (Nagy and Cenker, 2007), the self-perception of the role of audit partners (McCracken et al., 2008), the implementation of auditing standards (Mennicken, 2010) and the emotions experienced by auditors during an audit (Guénin-Paracini et al., 2014a,b). Such interpretive methods can enhance the reliability of statistical analysis by examining the complexities of practice (Cooper and Morgan, 2008) that underlie the observed associations.

The KH findings are surprising because we would expect auditors to increase their audit effort when they observe RPT-DOSs as this increases the riskiness of the audit. Qualitative research could usefully address the process by which audit fees are set and the perceived relationship between audit fee, and audit quality (see for example, Francis, 2004).

First, lower audit fees may be lower for reasons other than a demand for lower monitoring by the auditee management. Possibilities include senior management negotiating harder for lower audit fees in anticipation of lower future profitability or a shift in the balance of bargaining power between the auditee and auditor. Second, a lower audit fee may not be associated with lower audit quality. Given that audit firms are liable to reputational damage in the case of a material misstatement (DeAngelo, 1981; Barton, 2005; Skinner and Srinivasan, 2012), it seems unlikely that they would be willing carry out less work where a risk factor such as RPT-DOS is present. In the later years of the study, after the demise of Arthur Andersen, reputational issues and the presence of an audit committee would be expected to reduce the ability of the management team to negotiate for lower monitoring via a cut-price, low-quality audit.

Audit firm governance might also be worth exploring in future research, particularly with an investigation into the circumstances under which an audit partner would be capable of selling a low-quality, low-price audit to a high-risk client with an RPT-DOS. Field-based research could usefully investigate other factors, unrelated to audit quality, that might affect fee levels, for example geographical variations in location of the office that provides the audit (smaller regional offices might be expected to charge less than offices situated in a major city) or the negotiating strategy and success of individual audit partners.

One significant issue not analyzed in the study is the mechanism through which material misstatements are discovered and reported. KM state that evidence of the mechanism by which the material misstatement was identified is not available from archival databases. Given the hypothesis that poor accounting and the existence of RPT-DOSs is the result of poor "tone at the top", we would expect restatements to result from PCAOB reviews, or perhaps from a change to a new audit firm. However, if the misstatement is discovered by the senior management of the corporation, the hypothesis that the association found is due to "tone at the top" is challenged. Similarly, if the existing auditor discovers the material misstatement and reports it, the hypothesis that a low quality audit is associated with low audit fees is also less obvious, since it would be self-defeating for an auditor to sell and then uncover its own low-quality work. One possibility is that the auditor carried out more extensive audit work due to the higher perceived inherent and control risk of the audit as a result of the existence of the RPT-DOSs but that in some cases this did not result in the detection of a material misstatement until the following year. In this case, RPTs may be associated with an increased likelihood of restatement, not because of poorer reporting quality due to poor "tone at the top" but because RPT-DOSs are perceived by auditors as red flags and lead to greater scrutiny of the auditee. Hence, additional work is needed to clarify the reason for the restatement and thereby the underlying causal mechanisms at work.

3. Variables

Much qualitative work in accounting has emphasized the need for a contextualized, interpretation of phenomena under investigation, taking into account the characteristics of the local environment and cultural norms at play (Hopwood, 1979, 1983). The relevance of a contextualized interpretation for this study concerns the fact that RPT-DOSs and material misstatements are treated as binary variables. In reality, what constitutes an RPT-DOS or a material misstatement is less clear-cut, particularly cross-jurisdictionally and over time. Conceptual dynamism of this kind results from the following two factors: first, a changing environment influences how people interpret particular concepts. Second, as people respond to categorizations, they shift the meaning of the categories (Hacking, 1996). For these reasons, the assumption that the two key variables included in the study are static over time may be mistaken.

First, the term "related party transaction" is not only open to different interpretations but was in fact defined in different ways during the period of this study. KM focus on the US market and identify related party transactions by reference to proxy statements and 10-K filings, assuming that RPTs are disclosed in proxy statements. But this may not be the case as corporations can claim that amounts under $120,000 are non-material and need not be disclosed and also the information disclosed can vary between corporations (Min, 2014). Furthermore, the authors note in footnote 9 that the cut-off for related party transactions increased from $60,000 to $120,000 in 2006, but do not discuss two other changes to the disclosure requirements in S404, which include the expansion of the definition of "immediate family members" to include step-family and the removal of instructions concerning materiality. The fact that the concepts included in the model do not necessarily remain fixed over the period generates noisiness in the data. While qualitative work cannot resolve this data issue, interviews with CFOs, auditors and regulators may be useful in determining the extent to which these changes are a matter for significant concern.

Second, it is not clear that the term "material misstatement" can be treated as a binary variable legitimately. First, different kinds of material misstatement exist. A restatement relating to intangible assets that is perceived by users as inherently subjective may send a different signal to the market than a restatement of gross profit. Second, restatements are comparable between corporations and longitudinally only if the level of materiality is set consistently between companies. Yet many scholars have argued that materiality is a negotiated concept (Sikka et al., 1998; Power, 1997). One corporation may be subject to a restatement because its auditors identify a misstatement in its financial statements to be material, whereas another, with an error of a similar magnitude, may not be subject to a restatement if its auditors have set a different level of materiality. Evidence of the variation in materiality between corporations (and auditor firms) is observable in new long-form audit reports in the UK which require the disclosure of levels of materiality.[2]

Finally, field-based research could usefully disambiguate the term "tone at the top". KM argue that poor "tone at the top" reflects the self-interest of management and is associated with the likelihood of restatement, even after controlling for general corporate governance factors. Although existing research has highlighted the

[2] These requirements are set out in ISA (UK and Ireland) 700, FRC (2013) and reviewed in a 2014 report by Citi Research (Deans and Fisher, 2014).

importance of "tone at the top" for corporate governance and the quality of financial reporting, little has examined the associated firm-specific factors.[3] In fact, "tone at the top" may not be amenable to rigorous quantitative analysis because of its nature of a subjective and context-dependent composite term, much like "risk management" (Power, 2004) or "organisational culture" (Birkinshaw et al., 2011).

4. Cross-jurisdictional applications

The findings of the existing study have interesting implications for policy making, and could be extended to other jurisdictions. However, such an extension would demand a greater understanding of the regulatory and institutional environment in the new domains of application, not only because of differences in regulation but also enforcement (see for example, Licht et al., 2005; La Porta et al.; 2006; Leuz, 2010; Djankov et al., 2008; Jackson and Roe, 2009). Related party transactions are regulated by listing regulations, corporate law, financial reporting regulation and auditing regulation. KM focus on the disclosures required by federal securities regulation for their study but do not take into account the effect of any changes in the interpretation of corporate law as reflects the ex-ante authorizations and ex-post disclosure of RPT-DOSs. While this may be acceptable for the case of the US, the interaction of listing requirements, corporate law, financial reporting and auditing guidelines will need to be addressed if the study is to be extended to other jurisdictions.

Consideration of a selection of jurisdictions outside the US reveals subtle variations in reporting and disclosure requirements.

Canada: Two major regulatory authorities (Ontario and Quebec) use MI 61-101 to regulate RPTs. Unlike the US SEC, which focuses solely on disclosure for RPTs, the Canadian listing requirements require majority approval by minority shareholders and independent valuations for certain transactions. In part, the greater focus on related party transactions in Canada is associated with a higher proportion of public companies in Canada that are controlled by a single shareholder or group of

[3] But, see Schwartz et al. (2005) and Weber (2010) who identify "tone" (in a US environment) with general moral leadership manifested in a number of different types of behaviours and norms within the company. By contrast, other researchers have identified "tone at the top" with management-specific factors such as CFO's ability and age (e.g., Baik et al., 2011; Huang et al., 2012).

shareholders (25%) compared with the US (8%).[4]

Australia: Under Chapter 2E of the Corporations Act, a company must obtain shareholder approval to give a financial benefit to a related party. The Australian Securities & Investments Commission (***ASIC***) offers guidance on the circumstances in which an independent expert's report is expected to be distributed to members. RG76 provides for the disclosure of all related party arrangements to shareholders. There is no specific cut-off for materiality and instead the 'inconsequential' transactions must be disclosed to shareholders. ASIC does not define 'inconsequential'.

China: The Shanghai Stock Exchange does not permit loans to directors, supervisors or senior officers either directly or indirectly. Disclosure should be made of RPTs with natural persons for values over RMB 300,000 and to legal persons over RMB 3 million or 0.5% of the value of the company's net assets. However, the Chinese government is a related party for many listed companies, which were initially carved out of state organizations. This has resulted in an amendment to IAS 24 in 2008 to exclude government holdings from required disclosures under the standard.

India: Clause 49 of the Listing Agreement of the Securities and Exchange Board of India (SEBI, LC49) has recently been aligned with the Companies Act (Cos Act, 2013). All RPTs require audit committee approval and RPTs not in the ordinary course of business and not at arm's length require board approval. Additionally, approval by the company is required through a special resolution by disinterested shareholders for transactions exceeding specified thresholds.

Italy: Material RPTs are those for which the transaction value exceeds 5% of the higher of the shareholders' equity and the market capitalization, or 2.5% for a company controlled by another listed company. For these, management must circularise shareholders giving a description and the key terms of the RPT and these must also be disclosed in the half-yearly annual report. Approval is by a committee of unrelated directors, who have veto power for material RPTs.

UK: For companies with a premium listing on the London Stock Exchange, RPTs

[4] https://www.cpacanada.ca/business-and-accounting-resources/strategy-risk-and-goverance/corporate-governance/publications/controlled-companies-what-directors-should-know

must be disclosed. In addition, any loan of more than £10,000 must be approved by shareholders according to the UK Companies Act.

Figure 1 summarizes the different regulation covering RPT-DOSs for six jurisdictions in addition to the US. For all of these, legislation and listing regulations require at least ex-post disclosure of RPTs and, for many, certain RPTs such as loans to directors are either prohibited (US, China) or subject to ex-ante approval (UK).

Aside from regulatory issues, cultural factors also need to be considered for cross-jurisdictional applications. The quality of RPT-DOS as an indicator of poor "tone at the top" may vary in strength between different cultures. Outside the US, RPT-DOSs may be more common in which case they may be less likely to be associated with control weaknesses and more likely to be related to local social norms. In some cultures where capital markets are less efficient than in the US, transactions with related parties may reflect a means of reducing transaction costs (Coase, 1937), although admittedly, this is more likely to be the case for business-related RPTs than the RPT-DOS identified in the KM study. Nevertheless, in different regulatory and tax environments, we may expect RPT-DOSs to occur for short periods – for example as a tax efficient way of transferring funds to a shareholder when dividends are likely to be highly taxed. In these cases, the status of RPT-DOS as a red flag may be questioned.

Another factor that may affect the implications of RPT-DOS for accounting quality is variation in firm-ownership characteristics between countries. Differences in the concentration of ownership may vary between countries. Furthermore, variation in other ownership *characteristics*, such as the nature of dominant shareholders and ownership structure, may affect the extent to which related party transactions count as red flags. Family ownership, control rights, cash-flow rights and pyramidal ownership structures all affect risk of tunneling. Family-owned companies have been shown to be less likely to smooth income than non-family-controlled companies because family owners can mitigate the agency problem due to their ability to monitor managers (Shleifer and Vishny, 1997) or to take on the role of managers themselves and tend to report better quality earnings (Ali et al., 2007). Furthermore, family owners may have objectives beyond mere economic self-interest (Bubolz, 2001) but may place family-affiliated insiders in senior management positions (Fama and Jensen, 1983). Concentration of ownership in the US is relatively low as is family

ownership. Family controlled listed US companies were 34% of the S&P (Anderson and Reeb, 2003), and 45% of Fortune 1000 firms (Miller et al., 2007).

Let us consider, for example, corporate ownership in Canada, Italy and China. Corporate ownership in Canada is more concentrated than in the United States and uses multiple classes of voting shares and pyramidal structures more frequently (Attig 2005; Morck, Stangeland and Yeung, 2000). Studies of large Canadian companies find that over half the companies feature concentrated ownership, with families being the most common block-holder. Family-owners are more likely to use dual-class shares and pyramidal structures (Buckley, 1997; Attig, 2005; Morck et al., 2005), which may be associated with negative consequences for earnings management and accounting quality. Studies of Canadian companies have been inconclusive about the effect on performance of family ownership, although a recent Bank of Canada report does not find that concentrated ownership, whether by a corporation or financial institution, is associated with any change in performance. However, valuations of family-owned firms with dual-class shares are on average 17% lower relative to widely-held firms (King and Santor, 2008).

In Italy, an even higher proportion of listed companies have a single dominant shareholder or affiliated shareholders (Bianchi, Bianco and Enriques, 2001). Precipe et al. (2014) found that 70% of a sample of listed Italian companies were family controlled, which is consistent with earlier work by Corbetta and Minichilli (2005) which found that 67% of non-financial companies in Italy were family-controlled in 2003. Studies have found that family control is associated with reduced income smoothing for Italian listed companies (Prencipe et al., 2011).

For Chinese companies the state is often a dominant shareholder. Furthermore, even outside China, a concentration of ownership is higher in Asian companies (E&Y, 2014). Based on data for 2012, the report states that approximately 75% of issuers on the HKSE have a dominant shareholder who owns 30% or more of the issued shares. There is also a high level of connected transactions, mainly between the issuers and their major shareholder groups, which represent about 75% of the connected transactions disclosed in 2011.

These inter-jurisdictional differences in concentration and characteristics of ownership and control suggest that applying the KM model internationally, may

require an appreciation of the effects of the local ownership and control environment. Where family ownership mitigates agency issues, related party transactions with family members may exert the same effect on reporting quality as was found in the US. Further work could usefully identify relationships between RPT-DOS and earnings quality in jurisdictions with different ownership and control structures.

With regards to the audit fee model, cross-cultural variations in audit practice would need to be incorporated into the study if it were to be applied cross-jurisdictionally. Following the original work by Hofstede (1980), many studies have revealed that culture-specific factors may affect audit practice (for example, Cohen et al., 2010 and Parboteeah et al., 2005). Cultural studies have focused on the auditor's willingness to accede to client demands (Patel et al., 2002) and the likelihood of accounting errors in client accounts (Chan et al., 2003). Also, differences in ethical standards and the competence of accounting professionals may vary between jurisdictions along with organizational structures (Parboteeah et al., 2005). International variation in cultural and ethical norms may result in different levels of detection of misstatement and different fee negotiating practices.

5. Conclusion

The Kohlbeck and Mayhew (2017) study finds that simple RPT-DOSs are red flags for poor accounting quality associated with lower audit fees. The authors develop a model to explain these observations, suggesting that RPT-DOS is associated with poor "tone at the top" and that this leads management to negotiate for lower quality audits to minimize monitoring costs. Qualitative, field-based research may contribute to the refinement of the model by highlighting potentially relevant variables that may have been omitted as well as disambiguating complex variables such as "tone at the top" to make them more tractable. Furthermore, field-based research into practice, both within the finance function of corporations and within audit practice, could contribute by revealing the motivations of agents whose actions drive the observed statistical outcomes. Finally, the application of this model to test whether RPT-DOS is a signal of accounting quality in different cultures would be welcome.

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Figure 1: RPT-DOS Regulation

	Listing Rules	Listing requirements for RPT-DOS	Accounting regulation
US	Federal Securities Law SOX 402, 404 (2002) and 407 (2006)	Loans to directors banned, RPTs over $120k to be included on proxy statement (after 2006 ($60k before)	SFAS 57
Canada	Collection of regulators (CSA:10 provincial & 3 territorial). Multilateral Instrument (MI) 61-101, *Protection of Minority Security Holders in Special Transactions* applies in Ontario and Quebec (covering most large Canadian listings).	Majority approval of minority shareholders for related party transactions, with exemptions for transactions in the normal course of business or business combinations (Section 5.6).	IAS 24 (or Canadian GAAP Section 3850)
Australia	Australian Securities & Investments Commission (**ASIC**) Regulatory Guide 76 *Related party transactions* (***RG76***)	Disclosure and independent report – for all RPTs that are not `inconsequential'.	IAS 24
China	Chinese Securities Regulatory Committee	Shanghai: loans to directors not permitted. Material related party transactions are disclosed.	IAS 24
India	Listing Agreement, Clause 49	All RPTs require audit committee approval and all material RPTs require shareholder approval.	Ind. AS 24 (disclosure)
Italy	CONSOB Article 2391-bis (2004) Material RPTs are those for which the transaction value exceeds 5% of the higher of the shareholders' equity and the market capitalization (or 2.5% for a company controlled by another listed company)	Circularization of shareholders and approval by a committee of unrelated directors for material RPTs.	IAS 24
UK	UK Listing Rules, LR11	Circularization of shareholders and approval of RPTs	IAS 24