Journal of Indonesian Economy and Business
Volume 27, Number 2, 2012, 192 – 209

RELATED PARTIES' TRANSACTION AND EARNINGS MANAGEMENT: A CASE IN INDONESIA[1]

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ABSTRACT

This study investigates the association between related parties' transactions and earnings management in Indonesia. Firm's executives officers accompanied by board of director members usually engage in related parties' transactions to expropriate the firm's resources. Therefore, they have incentives to manage earnings either to increase their perquisites or possibly to mask such expropriation.

This study presents evidence that earnings management is positively associated with certain types of related parties' transactions. Overall, this study concludes that concerns about related parties' transactions as a factor associated with earnings management are warranted, especially for certain related parties' transactions. There are purchase costs from subsidiary or parent companies and expenses incurred from the firm's related parties' transactions.

Keywords*: related parties' transactions, perquisite, earnings management*

INTRODUCTION

This research is aimed to investigate the association between related parties' transaction and earnings management in Indonesia. Like the association between this transaction type and earnings management in the United States of America (Gordon & Henry, 2005), this association could be also evidenced in Indonesia. The company ownership structures in Indonesia are highly concentrated to one group, especially founding family (Claessens *et al*. 2002). It is used to fortify the interest of the company's own family founder (Shleifer & Vishny, 1997). The existences of this transaction were also supported by weak law enforcement and bad corporate governance that make the monitoring function becoming hard to be applied (La Porta *et al*. 1999).

The public companies in Indonesia were initially private companies founded by one family. The decision to seek fund from capital market was not fully followed by thorough issuance of company shares, nor even the

[1] We appreciate the helpful comments from I Made Narsa and Damai Nasution (Universitas Airlangga, Surabaya), Ratna Chandrasari (Universitas Negeri Yogyakarta), Sri Suryaningsum (Universitas Pembangunan Nasional, Yogyakarta). We are also grateful for financial support from the Center for Good Corporate Governance, Faculty of Economics & Business, Universitas Gadjah Mada. #This paper has been presented in The 9th Asian Academic Accounting Association in Kadir Has University, Istanbul, Turkey.

control over the company. Most of the issued company shares will actually come to the family founder back. One way of such control is establishing some subsidiary companies (if they are not yet exist before) and then sells most of the company shares to its subsidiary companies. Besides, to maintain the control over the company, the family of company founder holds the position within company management. Claessens *et al.* (2002) investigated and discussed about this.

Issuing their shares bought by either family founder or subsidiary companies and establishing new subsidiary companies did not occur by itselves. Gray (1988) argued that high tendency of collectivism, wide power distance, and high secrecy is common in East Asian companies, including Indonesia (Sudarwan & Fogarty, 1996). The argument above implies that many companies in Indonesia tend not to disclose too transparently about themselves, including their related parties' transaction.

The existence of related parties' transaction is not something prohibited. On the contrary, Indonesia Accounting Standard Boards (IASB) considers the related parties' transaction as normal transaction. However, IASB recognizes that related parties' transaction may have influence to the firms' financial position and income statements. The related parties may conduct transaction that cannot be done by ordinary related parties. This transaction can be done at the different price from similar transaction done by ordinary related transaction (Indonesia-SFAS No. 7, par. 6-7).

IASB attention to related parties' transaction in the matter of financial reporting in Indonesia is very relevant. Special-related parties' transaction is highly probable and even may dominate the most of all firms' transactions. Through special-related parties' transaction, company earnings can be really manipulated, so it looks better than actually, while the cash and earnings can be distributed among the companies within the group. This transaction is not only occurred in the companies at developing countries, but it is also occurred at advanced countries (Jian & Wong, 2003). Actually, several companies at developed countries also use the related parties' transaction to transfer their assets and earnings for the majority shareholders.

There are many examples in Indonesia that can serve as evidence. The example is Salim family company network, the main owner of public company PT. Indofood Sukses Makmur (ISM). ISM has wide network and even to the upstream, i.e. PT. Bogasari Flour Mills, the raw material main supplier of instant noodle ISM product. ISM also has connection to the funding resource, namely Bank Central Asia. Besides ISM, there are still many more, if not said almost all of them, other companies in Indonesia that also have special relation with one or more companies and do their various transaction types. However, as cited by IASB, the problems do not lay on the existence of special relation or on the transactions occurred among these parties. The problems arise when the executive officers or board of director members take the chance for their own interest from the company's special relation.

A lot of parties, such as regulators and market participants, consider the related parties' transaction as a potential conflict of interest. Having the authority upon various intercompany transactions, the managers have powerful incentives to deceive the shareholders control rights and to overcome the monitoring function of shareholders and board of directors. The deceitful managers may use this transaction to gain more benefits of their positions or use it to justify (or even to increase) perquisites that they would gain.

The theory expresses that there are at least two alternative perspectives about related parties' transaction, which each has different implication to the earnings management. The first perspective is that related parties' transaction raises the agency issue, similar to the

perspective by Jensen & Meckling (1976). According to this theory, the chief executive has incentive to manage earnings in order to justify their perquisites or even to secrete their company resources overspent. The second perspective states that related parties' transaction is merely rational company requirement to fulfill its economic objectives. By having special relation with other companies, a company binds itself with other parties to fulfill their economic requirement. For instance, by having special relation with other companies, a company may acquire knowledge and skills. In this case, the managers do not have incentive to manage earnings because there is nothing to omit or eliminate. As a bonding mechanism, the special relation binds the related parties. The tendency to take risky actions such as earnings management will only endanger the company or its related parties (Gordon & Henry, 2005).

Both the first and second perspectives are interesting when used to investigate whether the related transaction in Indonesia is used in order to manage earnings or just to fulfill rational economic requirement. Companies' managers with concentrated ownership structure have two contradictive possibilities of their behavior. First, according to alignment effect hypothesis, the managers of a company with concentrated ownership structure do not deceive and injure the minority shareholders. As a part of the company family owner, they are expected to report all transaction fairly. However, the second, entrenchment effect hypothesis expects otherwise. Because the law enforcement which does not support the property right well, the managers try to protect their own interest, which is to represent the control rights of company family founder or the majority shareholders (Shleifer & Vishny, 1997). Therefore, to protect themselves, there is a tendency to report transaction unfairly (Fan & Wong, 2002; Jung & Kwon, 2002). They conclude that discussion and empirical evidences pertaining to these hypotheses including empirical evidences have derived from both alignment effect hypotheses and entrenchment effect hypothesis in East Asia. They suggest that for all of transaction types that are most possible to be omitted is the related parties' transaction.

Moreover, to audit financial statements having much related parties' transaction is not an easy matter. AICPA (2001) gave three reasons why the parties having special relation and transaction with the special relation is hard to be audited. First, those transactions are not always easily identified. Second, even though other procedures have been conducted properly, the auditor usually let the management and the company owner to disclose their special relation with the other company and also the transaction among them. Third, those transactions are not always easily identified by the company itself.

Interesting empirical question from the discussion above is, considering legal condition, highly concentrated structure of ownership, and the cultural effects against accounting practice, whether related parties' transaction is used by the company to manage earnings or not. If empirically proven that related parties' transaction is associated with earnings management, the second question is which transaction is used to manage earnings, among all seven transactions that have to be disclosed according to Indonesia-SFAS No. 7.

The answers to these research questions give new perspective about how earnings management is conducted. Previous researches about earnings management, especially the ones using Jones model (Jones, 1991) or its modification (Dechow *et al.* 1995), have never differentiated the sales or transactions according to their nature: whether the transactions occurred among independent parties or not. The related parties cannot be considered as independent, even though legally they are different entities. Therefore, transactions among related parties can always be utilized for executive interest which in turn may injure

the interest of outsider or minority shareholders. The evidence of earnings management pattern among related parties may serve as input for the regulators and standard makers to public regulation, especially related to the related parties' transaction disclosure.

THEORITICAL FRAMEWORK

Accounting and Reporting Regulation

There are two main sources of accounting and reporting regulation on related parties' transaction, namely Indonesia-SFAS No. 7 and Indonesia SECs' regulation. Indonesia-SFAS No. 7 directs guidance to disclose transaction with related parties. Special-related parties' transaction also directed by Indonesia SECs' Regulation No.: VIII. G.7, about Financial Reporting Presentation Guide.

Indonesia-SFAS No. 7 states that parties who have special relation with the company are as follow, (1) company that control or being controlled or under common control with the company report publisher; (2) associated company; (3) company that has the right to vote at company report publisher and close family member of these individuals; (4) company key employee; and (5) company where the substantial interest in the right to vote is owned either directly or indirectly by each person described at point (3) or (4), or each person above has significant influence over the company.

Paragraph 17 regulates some examples of transaction that need to be disclosed which generally are all transactions that potentially influence the company performance, from sales and purchases of goods and services, transfer of assets, financing, and contracts. Paragraph 19 explains that each transaction has to be disclosed in transaction volume, number or proportion of intermediary items, and pricing policy.

Appendix No.: Kep-06/PM/2000 of Indonesia SECs' Regulation No.: VIII. G.7 regulates to disclose all companies' transaction with related parties. This regulation describes in detail that these transactions have to be disclosed, namely:

1. Detailed number of each account of assets, liabilities, sales and purchases (expense) to the related parties along with the percentage against total assets, liabilities, and sales and purchases (expense);
2. If the sum of each transaction or the balance of each category with certain party is greater than Rp1.000.000.000,00 (one billion rupiahs), the sum must be presented separately, the name and related party must be disclosed;
3. The explanation of transactions which are not related to the main operation and the sum of payable/receivable related to those transactions;
4. The nature of relation, types and elements of related transaction;
5. Pricing policy and transaction condition along with the statement of whether the application of pricing and condition policy are equal with the pricing and condition policy for transaction with third party; and
6. The reasons for the basic establishment of related receivable allowance.

In other side, both Indonesia-SFAS and Indonesia SECs' regulations also add a statement, "… notes on financial report must present separately the sum of each transaction and balance with the directors, employees, boards of directors, major shareholders, and parties which have special relation …" They actually show clearly that, even though the related transaction is normal activities during company operation, this transaction gives incentive to the manager to act deceitful for their own interests and disregard the shareholders interest. In the case of Indonesia, the minority shareholders who are not part of the family of company founder would be losses their welfares.

Earnings Management Literature

Earnings management occurs when the company managers use their discretionary accounting accrual in presenting financial statements and transactions controls. They do to deceive the outsider users about their base economic performance or to influence contractual output which depends on reported income numbers (Healy & Wahlen, 1999). Previous studies have tried to investigate the incentive and the mechanism of earnings management. However, most studies focused on earning management through financial reporting, especially discretionary accounting accrual. Jones (1991) developed a model using the change of incomes and property, plant, and equipments to estimate the nondiscretionary accrual. He found that the companies in industry which request the unlocked import faucet tend to decrease their discretionary accounting accrual during two or three years before.

Healy & Wahlen (1999) concluded that earnings management literature can only give modest input to the standard makers. According to them, the motivations of earnings management come from: (i) expectation and judgment of capital market, (ii) contracts they wrote in form of accounting income numbers, and (iii) anti-trust regulation or other government regulation. Their finding indicates that earnings management occurs for various reasons. Those are to influence the capital market perception, to increase management competency, to decrease infringement tendency of debt-contract covenant, and to avoid regulatory intervention.

In the matter of related parties' transaction, empirical research theory implies two alternatives of perspective. The first perspective states that related parties' transaction causes agency issue, as presented by Jensen & Meckling (1976). Jensen & Meckling categorized agency conflict between managers and outsiders shareholders as the managers' tendency to spend company resources for their personal interests, similar to perquisites. Accounting and business articles and accounting standards believe that related parties' transaction shows potential of company resources spending for personal interest, namely expropriation (Gordon & Henry, 2005).

If the company chief executives and/or the boards of director members will involve in related parties' transaction, their personal interest expenditure (perquisites), they would have incentive to manage earnings in order to justify (or to increase) their personal financing or to omit their personal expenditure. This perspective is consistent with the definition by Schipper (1989) about earnings management as an intentional intervention to the financial reporting process, in order to gain personal benefits.

Another perspective considers the related parties' transaction as another form of economic demand or a mechanism that binds one or more parties involved in the company (Gordon & Henry, 2005). For example, an associated company that is generally known to have considerable service knowledge is greatly required by another company. Therefore, it is more effective for the company to cooperate with its associated company rather than the other outsiders. In this case, it is reasonable that there is no incentive for the manager to manage earnings because such cooperation does not need to be covered up. Therefore, this relationship formulation does not give expected benefits for those companies from existence of the association between the earnings management and related parties' transaction.

The same logic is also applicable to explain someone's motivation having special relationship with the company. For example, the company employed the sons of chief executive officers or board of director members. Because of their occupancies, chief executive officers and his son depend on the company where they work, and then the chief executive will not take action that may endanger the

company, such as earnings management that may ruin the company or his son's relationship with the company. Another example, a board of director has a contract as a consultant company. If the board of director had tendency to manage earnings, his position within the board of director or his agency contract may be terminated. Therefore, as a bonding mechanism, transaction with related parties devotes a very limited or small incentive to drive earnings management.

Contradictive points of views about related parties' transaction show the complexity matters. The assumption hold by the standard makers is that such transaction is not conducted independently, unlike transaction between non-affiliated parties. A part of such transaction may be based on different recognition and measurement rather than regular transaction (US-SFAS No. 57, par. 3 and Indonesia-SFAS No. 7, par. 7). Accounting standards regulate to disclose these related parties transactions because the information contents of such transactions may be useful for the all of financial statement users to accounting information comparability (US-SFAS No. 57, par. 18 and Indonesia-SFAS No. 7, par. 18-19).

Related to the concern that such transactions were not conducted independently and fairly, many companies disclose that their contracts were made with related parties under conditions that were at least equivalent to any other parties. If a company conducted a transaction with certain parties having special relationship or at least could increase and did not reduce stock holders welfare, there would not be any negative impact for the company and there would not be any reason to manage earnings. However, according to Henry and Gordon (2005), due to the cost other than contracting cost, the disclosure of related parties' transaction does not always mean that the company is not affected by this transaction. There are some other economics costs for the company who conducted transaction with related parties, such as monitoring cost, opportunity cost, and reporting complexity cost.

Some research has been conducted to obtain deep understanding about this transaction. Gordon & Henry (2005), for instance, studied the relationship between this transaction and earnings management. They found evidences that adjusted absolute abnormal accrual are related to certain special party and to certain transaction type. They showed that transactions involving fixed rate interest financing with firms' related parties, either its existence or its sum of dollar, is associated positively with adjusted absolute abnormal accrual which serves as earnings management indicator.

Gordon *et al.* (2004) found that transaction with related parties usually associates with the corporate governance mechanism. It usually is marked with low management compensation and low market return. Kohlbeck & Mayhew (2004) found that some related parties' transactions associate with the chief executive compensation, while the others do not. Cheung *et al.* (2004) who studied in Hong Kong stock exchange finds that companies whose ownership characteristics is highly concentrated and institutional ownerships. The specific market characteristics in Hong Kong stock exchange have implied that traders of the concentrated shareholder ownership or institutional ownership are able to do stock trading with inter parties having special relationship. They find that positive abnormal return during the announcement of such transactions is associated with the ownership percentage of stockholder control rights and serves as a proxy of information disclosure. Jian & Wong (2003) proved that the debt-covenant companies report their sales level with the related parties' items higher than non debt-covenant companies. They had incentives to inflate their accounting earnings to avoid eviction from the stock market or before they issued new shares.

Studies related to board of director composition using the existence of related parties'

transaction are aimed to classify the member of non chief executive directors as affiliated or grey directors (Klein, 2002a; Vicknair *et al.* 1993; Hermalin & Weisbach, 1988). Affiliated board of director is considered as non independent member. Klein (2002b) examined the association between earnings management and audit committee independence and board of directors' independence. Based on the role of audit committee as the mediator who reduce conflict between management and auditor, they were expected to produce more accurate audit reports. Klien (2002b) hypothesized that an independent member of audit committee is the one who could play his role as an active supervisor against financial reporting process. He predicted that audit committee independence is associated negatively with earnings management. He later found that the audit committee independence and director independence are associated negatively with earnings management. In addition, he concludes that independent directors could monitor effectively firms' financial reporting process.

Hypothesis Development

The transaction between a company and its related parties can be seen from two perspectives; opportunistic and normal operational. Indonesia-SFAS No. 7 par. 16, for instance, states that the company transactions with its related parties are not always based on opportunistic motives. Special related parties' transaction might be possible because it must be done for the company survival. Furthermore, the affiliated company is the only one product buyers. However, unrelated to such matter, the manager's incentive to do opportunistic transaction with affiliated company is highly supported by the law enforcement. Within strong law enforcement, including the transparency reporting regulation, the incentive to deceit earnings management is less than within weak law enforcement.

The law enforcement in Indonesia is not yet strong, if not said otherwise. Within such enforcement, the way of company owner-founder to protect its property right is dominant ownership over the company at stock market (La Porta *et al.* 1999). Majority ownership is not the only way, so that they don't loose their control right over this company. To maintain their control right, the company must grow well. Company with good profitability has less probability to be overtaken by its competitors. Considering the ownership structure that is highly concentrated to one founding family because due to the weakness of property right regulation and managers as part of founding family, we may assume that company managers try not to loose their control rights. La Porta *et al.* (1999) suggests that the Indonesia companies before going initial public offering have previously set subsidiary companies to buy their issued shares. Most subsidiary companies usually have business line connected to parent companies. Thus, the incentive to do transaction with its related parties is clear enough. Similar to Klein (2002b), Gordon *et al.* (2004), and Gordon & Henry (2005), our maintained hypothesis is that related parties' transactions are associated with earnings management. Therefore, this study suspects that the related parties' transaction associated with earnings managements.

H1: Special-related parties' transaction items associated positively with earnings management.

RESEARCH METHODS

Sampling

The sample consists of all manufacture companies whose shares are listed at Indonesia Stock Exchange (IDX), that include all shares listed at Jakarta Stock Exchange before its merged with Surabaya Stock Exchange. The focus on manufacture companies was aimed to ensure that the conclusion is not affected by other industry characteristics. The weakness of this sampling method lies on its generalization

validity. However, in order to obtain stronger conclusion, the weakness has been minimized.

The companies included within sample should have complete financial data; those are cash flows, total assets, liabilities, sales, net income, and market value. Sample also should have adequate explanation about its related parties' transaction. Sample was selected from last ten years of reporting.

Operational Definition and Measurement

Independent Variable

The disclosure about parties who has special relationship with a company within sample may be obtained from the company financial report. Indonesia-SFAS and Indonesia SEC regulations require some related parties' transaction disclosure at financial statements. Special-related parties' transaction may be categorized into four dimensions, namely transaction involving primary parties, transaction involving secondary parties (if any), types of related parties' transaction, and the sum of related parties' transaction. Parties are considered as primary by their relationship with the company. These primary parties include management, board of directors, majority shareholder (owner), subsidiary company, associated company, and affiliated company.

Secondary parties consist of various individuals, such as family member of primary parties, company owned by primary parties, company that has the same key management as primary parties, primary parties affiliated company or parties, and management of subsidiary company. If transaction occurred directly between one primary party and company (for example, the company gave loan to its associated company), there would be no secondary parties involved.

The third dimension is the type of transaction. Various types of transaction are identifiable within this research, including direct service delivery between related parties, goods or services purchase contracts with related parties, sales to related parties, loan, investment, and others. The last dimension is the rupiah sum of transaction conducted by the company with its related parties. Principal summing was calculated for loan, fixed-interest rate financing, investment, and other single transactions. Annual summing is used whether transaction continue or occur frequently in sequential years such as goods/services purchase contract and sales.

Dependent Variable

This research uses abnormal accrual as earnings management measure. This measure has been widely used in earning management research. To calculate total accrual, this study starts from expected accrual estimation using modified Jones model (1991) as follows.

$$ACCR_{j,t}/TA_{j,t\text{-}1} = \alpha(1/TA_{j,t\text{-}1}) + \beta(\Delta REV_{j,t}/TA_{j,t\text{-}1}) + \gamma(PPE_{j,t}/TA_{j,t\text{-}1}) + e_{jt} \quad (1)$$

where, $ACCR_{j,t}$ is total accrual for company j during year t, which is net income subtracted by operating cash flow, $TA_{j,t-1}$ is total assets, $\Delta REV_{j,t}$ is change of net sales, $PPE_{jk,t}$ is gross value of property, plant and equipment (fixed assets), e is residual errors. Abnormal accrual is calculated using estimate resulted from equation (1), and then applied in the following equation (2).

$$AAC_{j,t} = ACCR_{j,t}/TA_{j,t\text{-}1} - [\alpha(1/TA_{j,t\text{-}1}) + \beta(\Delta REV_{j,t}/TA_{j,t\text{-}1}) + \gamma(PPE_{j,t}/TA_{j,t\text{-}1})] \quad (2)$$

where, $AAC_{j,t}$ is abnormal accrual for company *j* during year *t*. Abnormal accrual is used as independent variable to examine the association between related parties' transaction and earnings management.

Analysis Method

Unlike the independence of audit committee or board of directors, company-specific

scale for related parties' transaction is unclear. The logic measure of audit committee independence or board of director is the number of independent committee or directors divided by the sum of audit committee or board of director members. On the other hands, the absence of the sum of every transaction type and with which firms do relationships make company-specific scale of related parties' transaction identification to be difficult (Gordon & Henry, 2005). Therefore, this research examines various measures of related parties' transaction as independent variable, including number of company transaction types, whether the company has transaction with primary or secondary parties, or certain type of transaction, and sum of disclosed transaction, if available.

Later, this study calculates abnormal accrual for each measure of related parties' transaction. If earnings management did exist, positive and significant association between abnormal accrual and related parties' transaction is expected. This study constructs by adding other factors that have been known to have association with earnings management. This addition is important to prevent the mistake of null hypothesis rejection about the absence of abnormal accrual when the null hypothesis is actually true (Bartov *et al.* 2000; Klein, 2002b). Previous researches have found positive association between preceding year profitability with earning management. To capture expected growth, the researcher includes equity market value. Additionally, this research includes operating cash flow and one indicator for negative income to control other properties of accounting earnings and accrual. Previous researches have found that leverage associates positively with earnings management (DeFond & Jiambalvo, 1994). Finally, the researcher includes political cost measured by company value, because political cost has negative association with earnings management. This regression model is formulated in the following model (Gordon & Henry, 2005).

$$AAC_{jt} = \alpha + \beta RPT_{j,t} + \gamma_1 Abs(\Delta NI)_{j,t} + \gamma_2 MV/BVA_{j,t} + \gamma_3 OCF_{j,t} + \gamma_4 NegNI_{j,t-1} + \gamma_5 Debt_{j,t} + \gamma_6 Log(Assets)_{j,t} + e_{j,t} \quad (3)$$

where, AAC_{jt} is abnormal accrual for company *j* during year *t*, RPT is the measure of related parties' transaction, Abs(ΔNI) is absolute value of net income change divided by one year of total assets lag, MV/BVA equity market value divided by equity par value measured during the beginning of the year, OCF is cash flow during year *t* divided by total assets during the beginning of the year, NegNI is indicator variable which equals to one if the company reported negative earnings during preceding year and to zero if otherwise. Debt is long term liability divided by total assets at the beginning of year, and Log(Assets) is logarithm of total assets.

In order to examine further and to enhance the method used by Gordon & Henry (2005), this research re-investigates the previous regression examination result. This research examines by differentiating discretionary accounting accrual into positive and negative discretionary accrual as dependent variable. This considers the sensitivity in which the measure of related parties' transaction affects discretionary accrual. More specifically, this examination suspects that the one affected is not at the base of accrual measure, but the probability of increase or decrease of accrual measure. The formulation of regression is as follows.

$$Ln(V_{AACjt}/(1- V_{AACjt})) = \alpha + \beta RPT_{j,t} + \gamma_1 Abs(\Delta NI)_{j,t} + \gamma_2 MV/BVA_{j,t} + \gamma_3 OCF_{j,t} + \gamma_4 NegNI_{j,t-1} + \gamma_5 Debt_{j,t} + \gamma_6 Log(Assets)_{j,t} + e_{j,t} \quad (4)$$

where, V_{AAC} is the probability of increase or decrease of abnormal accounting accrual for company *j* during year *t*, other explanations of all independent variables are the same as

previously mentioned. The hypothesis that related parties' transaction associates with earnings management is when this RPT coefficient (β) variable from equation (3) and (4) have positive value and statistically significant.

RESULT ANALYSIS

Descriptive Statistics

The result of descriptive statistics examination is presented at Table 1. The mean of company sample that has income (in absolute value) is Rp140 billions, and the median equals to Rp30 billions. The operating cash flow has mean of Rp11 billions and median of Rp26 billions. Both mean and median values of operating cash flow show that sample curve tends more to the right side and the sample values lie more in the left side from normal curve. Similar conclusion is applicable for liability, but not for total assets that has been deflated by natural logarithm.

Table 2 presents the descriptive statistics of related parties' transaction form company sample. The mean of related parties' number own by a company equals to 8.18. A company, for example PT. Daya Sakti Unggul Corporation, reported the biggest number of related parties, which were 34 related parties during 1997. However, this number reduces to approximately nine percents during 2006. Using frequency distributions for each related party who did transaction with company sample shows highly rank. The highest frequency of related parties that have disclosed transaction equals to nine percent, which is at sixth grade special related parties. Eighty percent of observation sample reports the number of related parties under 12 parties.

Special-related parties' transactions which have zero values do not mean that the company did not do transaction with its related parties every year. For example, the zero value of related parties account receivable does not mean that there are no account receivable transactions or other receivables. The zero value only shows that the company did not disclose the transaction at all or disclosed the transaction but hidden the item number. Inversely, the company may not report the name of its related parties' items, but disclosed only its related parties' transaction. This research includes this transaction into analysis.

This research reviews that related parties and the transaction whose values presented at Table 2 is just as much as the financial reporting disclosure. Some companies clearly stated the item numbers, for example the employee and directors' receivables. Other companies only stated that such receivables did exist but did not disclose the item numbers of the receivables. Usually, they only showed that such receivables are combined with other assets into "other assets" classified-account. When this occurred, the researcher did not include into analysis.

Table 1. Descriptive Statistics

	ACC	Abs ΔNI	OCF	Neg NI	Debt	Log (Total Assets)
Mean	-0.2352	$1.379\text{x}10^{+11}$	$1.087\text{x}10^{+11}$	0.349	$0.383\text{x}10^{+12}$	11.818
Median	-0.1128	$2.983\text{x}10^{+10}$	$0.263\text{x}10^{+11}$	0.000	$0.715\text{x}10^{+11}$	11.810
Std. Dev.	1.2705	$2.708\text{x}10^{+11}$	$3.751\text{x}10^{+11}$	0.477	$0.108\text{x}10^{+13}$	0.520
N	450	450	450	450	450	450

Table 2. Descriptive statistics of related parties (SRP)

Panel A: Descriptive Statistics

	Special-related parties (SRP)					
	Sum	Acc. Receiv.	Income	Debts	Purchases	Expenses
Mean	8.18	$5.99x10^{+10}$	$1.14x10^{+11}$	$4.14x10^{+10}$	$4.15x10^{+10}$	$8.6x10^{+9}$
Minimum	0	0	0	0	0	0
Maximum	34	$1.77x10^{+12}$	$1.66x10^{+12}$	$1.04x10^{+12}$	$1.13x10^{+12}$	$3.8x10^{+11}$
N	450	450	450	450	450	450

Panel B: Distributive Frequency

	Frequency	Percent	Valid Percent	Cumulative Percent
0	25	5.6	5.6	5.6
1	31	6.9	6.9	12.4
2	23	5.1	5.1	17.6
3	40	8.9	8.9	26.4
4	26	5.8	5.8	32.2
5	31	6.9	6.9	39.1
6	41	9.1	9.1	48.2
7	26	5.8	5.8	54.0
8	31	6.9	6.9	60.9
9	30	6.7	6.7	67.6
10	22	4.9	4.9	72.4
11	12	2.7	2.7	75.1
12	22	4.9	4.9	80.0
13	8	1.8	1.8	81.8
14	15	3.3	3.3	85.1
15	14	3.1	3.1	88.2
16	8	1.8	1.8	90.0
17	9	2.0	2.0	92.0
18	5	1.1	1.1	93.1
19	5	1.1	1.1	94.2
20	2	0.4	0.4	94.7
21	1	0.2	0.2	94.9
22	7	1.6	1.6	96.4
23	1	0.2	0.2	96.7
24	2	0.4	0.4	97.1
25	1	0.2	0.2	97.3
26	2	0.4	0.4	97.8
28	1	0.2	0.2	98.0
29	1	0.2	0.2	98.2
30	3	0.7	0.7	98.9
31	1	0.2	0.2	99.1
32	2	0.4	0.4	99.6
33	1	0.2	0.2	99.8
34	1	0.2	0.2	100.0

Hypothesis Examination

Table 3 shows the result of bivariate intercorrelation examined variables. This relationship serves as initial evidence about the relationship among variables observed in this research. Abnormal accrual (AAC) has positive relationship with net income, dummy negative/positive income, and total assets. The relationship between income and abnormal accounting accrual that has positive sign shows that income associates with abnormal accrual. Inversely, operating cash flow associates negatively with abnormal accrual. This relationship is in accordance with the prediction of previous researches.

Table 4 shows the regression result between all variables within this research. The researcher conducts two kinds of regression. First regression is aimed to proof the existence of earnings management at company sample. Meanwhile, the second regression puts related parties' transaction variable into regression equation. There are six variables that are related to this transaction, namely sums of related parties who do transaction for all year long, receivables, incomes, debts, purchases, and expenses those occur due to company's transaction with its related parties. Each variable at the second examination is included into the regression model once only.

All seven regressions show F-values those are statistically significant. Adjusted R^2 values are approximately 28%, except the seventh equation. This result shows that the variables are associated with earnings management. The biggest F-value is shown by equation reg-7 that equals to 37.150. This high value is caused by significance of related parties' transaction variable. The detailed result for each variable is as follows. Net income shows positive signs and significant associations as predicted. From all seven regressions, it is shown that absolute income variable is always statistically significant. In other words, absolute income affects the managerial action to manage accounting and reporting its earnings.

Operating cash flow has direction that is in accordance with predicted signs. Because accounting is based on accounting accrual, the usage of cash basis is able to prevent earnings management, or at least cash basis has negative association with this managerial behavior. Basically, earnings management usually associates with the company operational activities, so that operating cash flow is suspected to have negative association with earnings management. The examination results present negative association evidence that is statistically significant for all equations. Negative income dummy variable values one if the company reported losses or zero if otherwise. Except for second and sixth equations, this variable does not show statistically significant results. It means that losses income numbers associates statistically significant with earnings management.

Table 3. Inter-variables correlation

	AAC	Abs ΔNI	OCF	Neg NI	Debt	Log TA
AAC	1					
Absolute NI	0,100*	1				
OCF	-0,382**	0,170**	1			
Negative NI	-0,135**	0.071	-0.092	1		
Debt	0,061	0,350**	0,372**	-0,049	1	
Log TA	0,190**	0,345**	0,329**	-0,104*	0,516**	1

Notes: *, ** significant at alpha consecutively 5%, and 1%.

Table 4. Linear regression results

Independent Variable	Coefficients						
	Reg-1	Reg-2	Reg-3	Reg-4	Reg-5	Reg-6	Reg-7
Absolute net income	$3.6x10^{-13}$*	$3.5x10^{-13}$*	$4.3x10^{-13}$**	$3.9x10^{-13}$*	$3.9x10^{-13}$*	$3.9x10^{-13}$*	$3.6x10^{-13}$*
Operating cash flow	$-1.8x10^{-12}$***	$-1.8x10^{-12}$***	$-1.8x10^{-12}$***	$-1.8x10^{-12}$***	$-1.8x10^{-12}$	$-1.9x10^{-12}$***	$-2.2x10^{-12}$***
Negative income dummy	-0.417***	-0.414	-0.412***	-0.391***	-0.420***	-0.398	-3.68**
Debts	$9.2x10^{-14}$	$9.2x10^{14}$	$9.8x10^{14}$*	$8.1x10^{-14}$	$9.6x10^{-14}$*	$1.1x10^{-13}$*	$1.9x10^{-13}$**
Log total assets	0.689***	0.664***	0.772***	0.669***	0.709	0.662***	0.566***
Sum of SRP	---	0.008	---	---	---	---	---
Receivables SRP	---	---	$-4.3x10^{-13}$	---	---	---	---
Income SRP	---	---	---	$3.4x10^{-13}$	---	---	---
Debts SRP	---	---	---	---	$-6.5x10^{-13}$	---	---
Purchases SRP	---	---	---	---	---	$8.3x10^{-13}$*	--
Expenses SRP	---	---	---	---	---	---	$8.6x10^{-12}$***
F value	36.321	30.405	30.653	30.749	30.511	31.057	37.150
Adj-R^2	28.2%	28.2%	28.4%	28.4%	28.3%	28.7%	32.6%

Notes: *, **, *** significant at alpha consecutively 10%, 5%, and 1%. The sum of related parties (SRP) is the sum of subsidiary/associated/ affiliated companies, including employees, directors, and shareholders, owned by either consolidated company or the one involved in one or more transactions between the company and its related parties; Receivables SRP is sum of account receivables and other receivables given by the company to its related parties, including receivables to employees, directors, and shareholders; Income SRP is sum of operating income and non-operating income within one year due to related parties' transaction; Debts SRP is account payables and other payables, including from employees, directors, and shareholders; Purchases SRP is purchases conducted by the company to its related parties; Expenses SRP is expenses paid by the company to its related parties. All transactions are included into this research, if only clearly disclosed in financial reports.

Special notes: this research did not include par value that is calculated by equity market value divided by equity par value at the beginning of the year (MV/BVA). The reason is data unavailability of stock value at closing end year and number of previous year stocks, considering the length of period required by this research.

DeFond & Jiambalvo (1994) suggests that leverage associates positively with earnings management. This study used long term debts as a proxy of leverage. Our current study shows results that debts associate positively and statistically significant at three of four regression equations. However, at first equation, debts are unable to explain statistically about the behavior of earnings management.

Total assets as a function of political costs hypothesis do not have sign direction as predicted. The sample does not show that political costs are the consideration for the company to do earnings management. The behavior of company managers is not to lessen company assets when they manage their earnings. This phenomenon is completely different from political costs hypothesis which predicts that company tends to avoid it (Watts & Zimmerman, 1986).

From six variables of related parties, only the purchases variables between the company and its related parties and expenses of related parties' transaction that is statistically significant. The company sample does earnings management by increase its purchases with its related parties. Additionally, this examination shows transactions that make the company managers to put transaction expenses in its financial reports that positively affect earnings management. Both purchases and transaction expenses has relationship in the process to affect earnings management. The reason is, both purchases and transaction expenses are to be used as tools to lower company income. Greater purchases raise costs of good sold and then decrease their income. Similar process applies to transaction expenses. Therefore, the regression result is coherent with the conclusion of dummy variable above.

Sensitivity Analysis

To re-examine the result of linear regression test, this research do similar variables

using probabilistic regression which is based on the probability of positive and negative abnormal accrual. The detailed result is presented at Table 5 as follows.

All seven probabilistic regressions show result of -2 log likelihood values which are statistically significant. Negelkerke-R^2 values are approximately 26%. This result implies that probabilistic regression examination strengthen the validity result that has been obtained from linear regression examination. The associations between various variables and earnings management are relatively equal which are explained in detail as follows. The change of absolute net income does not affect abnormal accrual during the equivalent years. Meanwhile, operating cash flow, negative income, debts, and total assets are always statistically significant and have signs those are in accordance with prediction. In other words, all variables except net income affect the action of company earnings management.

From six related parties' transaction variables, only purchases between the company and its related parties are statistically significant. This means that the companies sample do their earnings management by increasing the sum of purchases to its related parties. This only one, that is purchases, has association in its process to affect earnings management. Therefore, this study concludes that purchases are tool used to lower current accounting income. Greater purchases increase the cost of good sold and then lower accounting income.

FINDINGS AND DISCUSSION

This research finds that purchases have relationship with earnings management. This finding is highlighted that most Indonesia companies are subsidiary of other foreign companies. This relationship shows that most Indonesia companies have capital dependency to their parent companies abroad. Because of subsidiary company, it often does purchases from parent company, for instance, PT. Voksel Electric reported purchases raw material and spare parts from its affiliated company up to 81% from its total purchases during 2004. This fact indicates that Indonesia firms depend upon their parent company, especially on raw material imported for their products. However, not every company should depend on raw material from abroad. For example, PT. Barito Pacific Timber even sells its products to its parent company abroad. This research suspects that different business characteristics among Indonesia companies make purchases significance to be just at the level of 5%.

Table 5. Probabilistic regression result

Independent Variable	Coefficient						
	Reg-1	Reg-2	Reg-3	Reg-4	Reg-5	Reg-6	Reg-7
Absolute net income	0,000	0,000	0,000	0,000	0,000	0,000	0,000
Operating cash flow	0,000***	0,000***	0,000***	0,000***	0,000***	0,000***	0,000***
Negative income dummy	-1,341***	-1,341***	-1,345***	-1,360***	-1,363***	-1,403***	-1,345***
Debts	0,000*	0,000*	0,000*	0,000*	0,000*	0,000	0,000
Log total assets	1,000***	0,995***	1,083***	1,017***	1,056***	1,609***	1,008***
Sum of SRP	---	0,003	---	---	---	---	---
Receivables SRP	---	---	0,000	---	---	---	---
Income SRP	---	---	---	0,000	---	---	---
Debts SRP	---	---	---	---	0,000	---	---
Purchases SRP	---	---	---	---	---	0,000**	--
Expenses SRP	---	---	---	---	---	---	0,000
-2 log likelihood	523,849	523,830	522,101	523,553	521,524	517,637	523,794
Negelkerke-R^2	26,6%	26,6%	27,0%	26,6%	27,1%	28,0%	26,6%

Notes: *, **, *** significant at alpha consecutively of 10%, 5%, and 1%.

Another significant variable is expenses of related parties' transaction. This variable affects earnings management at significance level of 1%. Unlike the explanation about purchases from related parties above, expenses are relatively easier to use for parent or subsidiary company as earnings management instruments. This expenses charging can be used by the company to lower its earnings during a period and report earnings lower than it should be.

Both expenses and purchases provide incentives for managers to lower their company earnings. This result supports the finding of negative income dummy variable. It means that company sample tendency is to lower accounting income than otherwise. More specifically, companies tend to use purchases and expenses transaction as tool to lower their reported income. The usage of purchases and expenses transaction to lower reported income can be explained by observing the macro economics condition around research observation period. Since 1995, Indonesia governmental regulation has required all companies who have more than Rp100 millions accounting income to aid Yayasan Sejahtera Mandiri. This policy obviously burdens the companies and serves as trigger for the companies to report lower income than it should be. Even though, this obligation has been abolished at 1998 or 1999, marked by its absence at financial reports, but then macro economic condition has worsen because of economic crisis. This crisis made most companies tend to report lower reported income even more. The recovery which is time consuming makes earnings management practice with predisposition to lower reported income occurs again.

CONCLUSION

From data observation, this research concludes that not all companies within sample report and own related parties transaction as stated Indonesia-SFAS No. 7. From 450 observations, as many as 5.6% observations have related parties which equal to zero. This research presents evidence that earnings management measures are positively associated with limited types of related parties' transactions. Overall, this study concludes that concerns about related parties' transactions as a factor associated with earnings management are warranted, especially for certain related parties' transactions. There are purchase costs from subsidiary or parent companies and expenses incurred from the firm's related parties' transactions.

However, this absence of related parties reported by companies in financial report has three possibilities of reasons. *First*, the companies do not really have related parties who do transaction with the companies during reporting year and there are not any transactions with related parties to be reported during the current year. *Second*, the companies actually have transactions with related parties but did not report which related parties, although the transactions and their sums were disclosed. This occurred when the currency values of the transactions were considered relatively small so that they were included into account of "purchases to related parties", without explanation about which these related parties are. As previously mentioned, this research included zero value as the sum of related parties, even though in fact this research included transactions value according to their groups and their sums.

Third, companies actually have transactions with related parties but did not disclose them in their financial statements. This was found at the notes of financial statements which implied that those transactions occurred, such as the company dependence to raw material from associated company abroad. Such phenomenon was normal considering that related parties' disclosure and their transactions depend on chief executives and board of directors' desires. Companies such as Medco Energy[1], have tens subsidiary companies and disclose them in financial statements.

Actually, the company only disclosed some of them. The financial statement users can only rely on the accounting information disclosed.

The full, fair or adequate disclosure of related parties and their transactions was affected by various factors, from management culture to disclosure costs. Additionally, related parties' transactions have operational and economic motives. Therefore, the expression that related parties' transactions were conducted under the same condition as third parties transactions, the related parties' transaction disclosure may be considered by the chief executives and board of directors or auditors as uneconomical and do not affect the firms' fundamental value. The majority control rights among companies which are very complicated makes the disclosure become expensive for the company.

The related parties' transaction disclosure becomes sensitive for the company when such transactions involved stockholders or company founders. Transactions that usually occur between company and stockholders are other payables-receivables. Only few number of companies within sample disclosed that the company conducted transactions with stockholders and the full disclosure of involved stockholders' names. Usually such transactions were disclosed under "receivables to stockholders" or "payables from stockholders" labels without full disclosure of involved stockholders' names.

The disclosure by company was not entirely adequate so it covers who and how much transaction between the company and its related parties had been recognized. Some companies only disclosed in narrative form which stated those related parties' transactions have occurred without detailed explanations about the sum of transactions. The presented figures are the only evidence of a certain figure. For example, some companies disclosed its purchases to related parties compared to total purchases. Some other companies even disclosed in rough percentage by adding "approximately." Besides the transaction disclosure which is unclear, there is no uniformity on the disclosure among companies. Some companies disclosed their transaction, such as account receivables to related parties under account receivables group. Meanwhile, some other companies separated their third parties from related parties. However, it is not uncommon that companies disclosed these transactions under sections other than transactions as found in this study. For example, costs occurred from agreement, such as royalty payment to principal, were disclosed under the group of "agreement or contracts and bonding."

Culture (Gray, 1988; Sudarwan & Fogarty, 1996) and weak law enforcement in Indonesia (La Porta *et al*. 1999) serve as explanation about evidence that the disclosure of Indonesia companies were bad and irregular. Most Indonesia companies were founded by family and they want to stay in their companies because they do not want to loose their ownership entirely. Secrecy is often considered as one way to maintain their control rights. When it was chosen, then the disclosure becomes weak and bad.

Company is the only side who understand certainly with whom the firm management does transactions. Not only have the users of financial report depended on full information disclosure from companies, but it also does the auditors. This study is only able to identify related parties as long as they were disclosed by the company. In this research, we find that company did transactions with other companies or subsidiary companies whose names those were so much alike, but they were still

[1] This research excluded this company from sample for changing its functional currency from Indonesian rupiah to US dollar during 2002. This change caused the variables measurement become hard, because some transaction used currency exchange rate at transaction date, such as sales. Meanwhile, some other transactions used historical currency exchange rate, such as fixed assets.

considered as third parties. However, they were reported as related parties a few years later. This shows that executive officers and board of directors are the only information sources and firm disclosures are the only ones which can be used by financial statement users.

Further research is recommended to improve the metric of related parties' transactions measurement. This research used the metric of research by Gordon & Henry (2005). The research acknowledged that this metric is not yet good enough to capture the phenomena of related parties' transactions. Some transactions were used overlapping in examinations, for examples, sales transactions. Jones' model (1991) uses sales to estimate accrual. The sales values itself were previously used to determine abnormal accrual. Our study concludes that the procedures of accrual estimation and its association with sales becomes bias to conclude.

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