RELATED PARTY TRANSACTIONS AND EARNINGS MANAGEMENT: THE MODERATING ROLE OF THE AUDIT COMMITTEE

Marina Elistratova[a], Carolina Bona-Sánchez[b], and Jerónimo Pérez-Alemán[c]

[a]*Department of Financial Economics and Accounting, University of Las Palmas de Gran Canaria, Las Palmas de Gran Canaria, Spain*

[b]*Department of Financial Economics and Accounting, University of Las Palmas de Gran Canaria, Las Palmas de Gran Canaria, Spain*

[c]*Department of Financial Economics and Accounting, University of Las Palmas de Gran Canaria, Las Palmas de Gran Canaria, Spain.*

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ABSTRACT

Recent corporate scandals have drawn attention to related party transactions (RPTs) and particularly to the influence of these transactions on financial reporting quality. However, the literature that analyzes the relation between RPTs and earnings management is very scarce and focused on East Asian countries. On the current paper, we extend this line of research by analyzing the relation between RPTs and earnings management in a Continental European setting. By using a sample of Spanish listed firms over the period 2004-2014, we find a positive relation between the amount of RPTs and accruals earnings management. Further analysis shows that financial reporting discretion is less predictive of future operating cash flows in firms engaging in RPTs. Finally, we provide empirical evidence on the role of the audit committee for the relation between RPTs and earnings management. Particularly, our results reveal that an audit committee, which meets the best audit committee guidelines, moderates the positive association between RPTs and earnings management.

1. INTRODUCTION

Financial scandals of the last decades have threatened the credibility of financial reporting. In such a context, RPTs have been a major concern. These diverse and often complex transactions have attracted academics' and policy-makers' attention and their regulation has become a priority in the international agenda.

Spanish stock market has not been away from this trend. Thus, about 50% of Spanish listed firms have engaged in RPTs during the period 2004-2014 (Elistratova, Bona-Sánchez, and Pérez-Alemán, 2016). Moreover, Spanish regulators have undergone significant legislative changes in order to increase transparency concerning RPTs (*e.g.,* Law 44/2002; Law 26/2003; Order EHA/3050/2004).

RPTs may be efficient transactions crucial to the firm's long-term survival during a financial crisis (*e.g*., Chang and Hong, 2000; Khanna and Palepu, 2000). However, previous literature has also highlighted significant risks associated with RPTs. In this sense, previous studies (*e.g*., Johnson, La Porta, Lopez-de-Silanes, and Shleifer, 2000; Bertrand, Mehta, and Mullainathan, 2002; Berkman, Cole, and Fu, 2009) evidence that RPTs are widely associated with tunneling activities. In this sense, Leuz, Nanda, and Wysock (2003) pointed out that earnings management may be used to obscure previous expropriation activities to conceal the private control benefits.

However, the literature that analyses the relation between RPTs and earnings management is scarce and mainly based on East Asian countries (*e.g*., Aharony, Wang, and Yuan, 2010; Jiang and Wong, 2010; Chen, Cheng and Xiao, 2011; Hwang, Chiou and Wang, 2013; Shin, Sohn and Park, 2019). Thus, their results are hardly extrapolated to Continental Europe due to institutional differences. In this sense, while the main goal of Spanish listed firms is shareholders' wealth maximization, in the context where previous studies have focused, corporations prioritize state objectives over business goals (Global Affairs Canada, 2017). As a result, the incentives for earnings management significantly differ along these two settings. Moreover, previous studies mainly focus on specific types of RPTs and on particular earnings management settings (*e.g*., Aharony, Wang, and Yuan, 2010; Jiang and Wong, 2010; Chen, Cheng and Xiao, 2011).

In the current paper, we investigate the relation between RPTs and earnings management in a sample of non-financial Spanish-listed firms during the period 2004-2014. Our results show a positive relation between RPTs and earnings management.

Furthermore, we find that discretionary accruals are less predictive of future cash flows in firms undertaking RPTs. This result indicates that rather than resorting to earnings management to signal the controlling shareholders' private information, these accounting choices are driven by the controlling shareholders' opportunism. Finally, our results reveal that an audit committee which complies with the best audit committee guidelines moderates the positive association between RPTs and earnings management. Thus, in the considered setting, such compliance becomes an effective corporate governance mechanism in constraining opportunistic earnings management.

We contribute to the previous literature in several ways. First, we provide novel evidence on the consequences of RPTs in the capital markets by providing evidence that RPTs promote opportunistic earnings management in a Continental European setting. Second, by showing that an audit committee which complies with the best audit committee guidelines reduces the controlling shareholder's likelihood to resort to earnings management, we provide support to the recent initiatives adopted by Spanish regulators aimed at strengthening the role of the audit committee as a corporate governance mechanism.

The rest of the study is organized as follows. Next section provides the theoretical background and the hypotheses development. Section 3 describes the methodological issues and in section 4, we present our findings. Finally, section 5 concludes the study.

2. THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

Institutional features shape the aim of RPTs (*e.g*., Johnson *et al*., 2000; Bertrand *et al*., 2002; Friedman, Johnson, and Mitton, 2003; Kahle and Shastri, 2004; Cheung, Qi, Rau, and Stouraitis, 2009; Berkman *et al.,* 2009). In this sense, some studies have considered that RPTs affect firm value (Khanna and Palepu, 2000; Ryngaert and Thomas, 2008; Lei and Song, 2011; Bona-Sánchez, Fernández-Senra, and Pérez-Alemán, 2017) and reporting policies (*e.g*., Aharony *et al*., 2010; Jian and Wong, 2010; Chen *et al*., 2011; Wang and Yuan, 2012; Hwang *et al.,* 2013; Lee, Kang, Lee, and Park, 2016).

Thus, in a sample of listed firms in China, Aharony *et al*. (2010) evidence that related-party sales of goods and services are not an efficient business choice but on the contrary, they are used opportunistically to increase earnings in the pre-IPO period. Additionally, they provide evidence that inflating earnings in the pre-IPO period is motivated by the prospect of tunneling opportunities in the post-IPO period. In a similar vein, Chen *et al*.

(2011) find that Chinese controlling shareholders opportunistically engage in operating RPTs to increase the reported earnings in the pre-IPO period. Also in the Chinese context, Jian and Wong (2010) document that related sales affect firm's propensity to manage accruals to meet security regulators' earnings targets to help the listed firms to maintain their listing status.

While previous studies focus on particular RPTs such as related party sales and on particular earnings manipulation settings, other studies offer a more general approach considering that company managers can use different combination of RPTs to manage earnings. Thus, in a sample of Taiwanese firms operating in China, Hwang *et al.* (2013) find that disclosure regulation helps firms to reduce earnings management practices linked to RPTs. Finally, Shin *et al*. (2019) find that in Korean public companies managers use RPTs to smooth income in order to improve the informativeness of the firms' reported earnings about their future earnings.

As shown, the literature that links RPTs to earnings management is recent and scarce and consequently far from conclusive. Furthermore, previous studies are mainly based on East Asian countries and on specific types of RPTs. Therefore, the results from previous studies are hardly extrapolated to Continental Europe. Thus, while in China the state is the ultimate shareholder of the majority of listed firms (Chen *et al*., 2011), in Spain state ownership is practically non-existent, and a high percentage of listed firms is effectively controlled by families and financial institutions (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Cuervo, 2002). In this sense, while the main goal of Spanish listed firms is shareholders' wealth maximization, Chinese listed firms give priority to state's objectives over business goals (Global Affairs Canada, 2017). Therefore, Chinese firms are often designated to undertake public policy goals related to macroeconomic stability and social improvement (Song, 2018). Second, and in contrast to Spanish firms, Chinese listed firms have additional pressure to fulfill the earnings targets imposed by Chinese government in order to maintain their listing status (Chen, Lee, and Li, 2008; Jian and Wong, 2010). Additionally, if Chinese listed firms report losses, they may be subject to closer government scrutiny (Jian and Wong, 2010). Meanwhile, the South Korean economy is almost fully controlled by large family business groups named *chaebols,* which has been generously supported by Korean government in the form of subsidies, loans, and tax incentives and become the pillars of the South Korean economy (Choi, Kang and Lee, 2018) Thus, similar to the Chinese corporations, Korean firms are concerned with substantive social and economic goals (Whitley, 1991) and receive

strong government support (Choi, Kang and Lee, 2018). On the contrary, Spanish companies are monitored by market forces and not by regulators. These institutional differences translate into important variations in internal agents' ability and incentives to resort to earnings management. Thus, the relation between RPTs and earnings management in Continental Europe becomes an unresolved research issue.

Spanish institutional environment is characterized by weak investor protection and high ownership concentration as well as by the presence of pyramidal structures, which facilitate the controlling shareholders' entrenchment (La Porta *et al*., 1999). This context increases previous shareholders' incentives to opportunistically engage in RPTs, because on the one hand, pyramidal structures enable the controlling shareholders to maintain tight control of the firm while committing low equity investment, creating this way a divergence between ownership (cash flow) and control (voting rights). This divergence increases the controlling shareholders' incentives to use RPTs to tunnel the firm's resources. On the other hand, the features of the Spanish institutional setting reduce the likelihood that these opportunistic transactions could be effectively persecuted and penalized (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998). In such a setting, the controlling shareholders increase their incentives to manage earnings in order to obscure the opportunistic use of RPTs. By resorting to earnings management, the controlling shareholders try to project a positive image of their own performance, protecting their reputation and reducing the probability of outside interference (Haw, Hu, Hwang and Wu, 2004).

By contrast, controlling shareholders often have a large part of their wealth directly tied to the firm and consequently they perceive the firm's financial health as an extension of their own well-being (La Porta *et al*., 1999; Cuervo, 2002). Thus, the high ownership concentration, which characterized Spanish listed firms, may help them to engage in efficient RPTs because higher ownership concentration increases the costs borne by the controlling shareholder when adopting opportunistic RPTs. In such a setting, controlling owners might be more prone to use RPTs efficiently. In this sense, previous literature shows that RPTs could be an efficient contracting mechanism that reduces transactions costs, increases property rights protection and facilitates contracting (Coase, 1937; Khanna and Palepu, 2000; Fisman and Khanna, 2004; Fan and Goyal, 2006). In such a setting, controlling shareholders may be more likely to engage in RPTs to create internal capital markets, which allow them to transfer funds from one company to another in order to finance future investment opportunities or provide financial support during a crisis

period (Chang and Hong, 2000). Thus, the existence of financing sources other than those provided by external capital markets makes the firms belonging to a pyramidal group less sensitive to capital market pressures (Almeida and Wolfenzon, 2006). A lesser need to resort to external capital markets will reduce the controlling shareholder's incentives to manage earnings because such a setting reduces the controlling shareholder's need to contract based on the company's financial position and encourages relationship contracting.

Furthermore, signaling theory should also help to explain the positive relation between RPTs and earnings management. In this line, Shin, *et al*. (2019) document that managers of Korean listed firms smooth earnings to signal private information about the firms' future earnings performance. Thus, if RPTs are efficient contracting mechanism and help to align the controlling and minority shareholder's interest, controlling shareholders may resort to earnings management to reduce information asymmetries and signal their private information to the market.

According to all the above, the relation between RPTs and earnings management in the Spanish context is an empirical question. Thus, we state our hypothesis as follows:

H1: RPTs affect earnings management

3. RESEARCH DESIGN

3.1. Data

The financial data are taken from Osiris database by Bureau van Dijk Electronic Publishing (BvDEP). We hand collect data about RPTs because this information is not publicly available. The sample comprises a non-balanced panel data of 93 non-financial Spanish firms listed on the electronic market for the period 2004-2014. As a result, we obtain 786 firm-year observations. In order to eliminate the adverse effect of the extreme values, we winsorize all continuous variables at the 1% and 99% levels.

3.2. Earnings management

In line with the previous literature, we use two alternative measures of earnings management based on discretionary accruals. Specifically, we use the Jones' model (1991) as modified by Dechow, Sloan, and Sweeney (1996) and Kothari, Leone and Wasley (2005).

In this way, in the first place we estimate the coefficients of the following equation (Ec. 1):

$$\frac{AC_{it}}{TA_{it-1}} = a_0\left(\frac{1}{TA_{it-1}}\right) + a_1\left(\frac{\Delta REV_{it}}{TA_{it-1}}\right) + a_2\left(\frac{PPE_{it}}{TA_{it-1}}\right) + a_3 ROA_{it} + \varepsilon_{it} \quad (1)$$

Where AC_{it} is the total amount of accruals. ΔREV_{it} is the change in revenues, PPE_{it} is the level of property, plant and equipment, ROA is income before interest and taxes divided by total assets and TA_{it-1} is the total assets of the firm i at the beginning of year t, and ε_{it} is the error term.

Then we obtain our measure of earnings management (Dechow *et al*., 1996 and Kothari *et al*., 2005):

$$DA_{it} = \frac{AC_{it}}{TA_{it-1}} - \hat{a}_0\left(\frac{1}{TA_{it-1}}\right) + \hat{a}_1\left(\frac{\Delta REV_{it} - \Delta AR_{it}}{TA_{it-1}}\right) + \hat{a}_2\left(\frac{PPE_{it}}{TA_{it-1}}\right) + a_3 ROA_{it} \quad (2)$$

Where ΔAR_{it} is the change in accounts receivables.

For robustness check we use the amount of the current discretionary accruals as our second measure of earnings management (Peasnell, Pope, and Young, 2000). Thus, we estimate current discretionary accruals using the previous equation excluding the level of property, plant and equipment. In this sense, Consequently, we obtained two dependent variables: *ADA,* the absolute value of discretionary accruals and A*CDA,* the absolute value of current discretionary accruals.

3.3. Related party transactions

Previous literature has categorized RPTs according to two different criteria, namely, the nature of the transaction and the party involved in it. In relation to the first criteria, some previous studies have focused on one particular type of RPTs, such as related lending or operating transactions (*e.g.,* Aharony *et al*., 2010 Berkman *et al*., 2009; Chen *et al*., 2011), while other authors have focused on all types of RPTs (Kohlbeck and Mayhew, 2010, 2017; Hwang *et al*., 2013).

Within the second criteria, Kohlbeck and Mayhew (2010) separate the transactions with shareholders, managers, and directors and transactions with unconsolidated subsidiaries, while Kohlbeck and Mayhew (2017) add to the latest category the *joint ventures.* Similarly, Nekhili and Cherif (2011) divide RPTs in two categories: transactions that probably result in expropriation (transactions with shareholders, directors or managers, and the companies in which they are affiliated) and transactions that probably do not result in expropriation (transactions with subsidiaries and associated companies).

In the Spanish context, the law 26/2003 defines RPTs and makes compulsory for Spanish listed companies to disclose RPTs in the annual corporate governance report. Thus, we hand-collect this information from previous report and identify 17 different types of RPTs. However, in line with Hwang *et al.,* (2013), in the current study we focus on the total amount of RPTs. Regarding the related party involved in the transaction, Spanish listed firms disclose in the annual corporate governance report: (1) transactions with the main shareholders, (2) transactions with directors and managers, (3) transactions with other entities of the group not eliminated on the consolidation process and excluded from the ordinary business of the company and (4) transactions with other related parties. In the current study, we focus on transactions with the main shareholders, directors and managers, which represents the 95,20% of the total RPTs accomplished by Spanish listed firms.

3.4. Control variables

According to the previous literature, we include in our analysis a set of control variables that may affect the amount of discretionary accruals (Burgstahler and Dichev, 1997; Becker, Defond, Jiambalvo, and Subramanyam, 1998; Klein, 2002; Piot and Janin, 2007; Gopalan and Jayaraman, 2012; Hwang *et al*., 2013). In this way, services provided by larger audit firms are often linked to higher audit quality because of their greater experience and technical expertise. Consequently, BIG 4 audit firms may discourage earnings management. Thus, we include in our empirical analysis the variable BIG4. Additionally, high level of leverage and low profitability may increase the firm's incentives to manage earnings, so we control for firm's leverage (LEV) and profitability (ROA). In the same way, we control for the firm's losses by including the variable LOSS. Moreover, previous literature finds that absolute variations of the firm's income may increase discretionary accruals. For this reason, we include the variable ABDIF. We also control for firm's size (SIZE) and growth (MKBOOK), because they may affect the incentives to manage earnings. Finally, a higher controlling owner's voting-cash flow wedge may increase the controlling shareholders' incentives to opportunistically engage in RPTs and to manage earnings to conceal this opportunistic behavior. Thus, we include the variable DIVERG to control for this possible incidence on earnings management. Appendix 1 lists the definitions of all variables used in this study.

4. RESULTS

4.1 Descriptive analysis

Table 1 (Panel A) shows the evolution of the value of RPTs and their percentage to total assets along the period. Thus, the higher amount of RPTs corresponds to the year 2006 and the lowest to the year 2004. In the same way, it is remarkable that during the years 2005 and 2006 the value of RPTs exceed 10% of the total value of the firms' assets, which reveals the relevance of these transactions in Spanish listed firms.

Table 2 includes the descriptive statistics. Thus, panel A shows the average of the absolute value of discretionary accruals (0.10) and the absolute value of current discretionary accruals (0.08). The average RPTs is 0.03, while the average controlling shareholder's voting-cash flow wedge (DIVERG) is 3.83%, which means that on average controlling shareholders in Spanish listed firms possess 3.83% more voting rights than cash flow rights. Panel B (Table 2) shows the correlation matrix. Although a high correlation can be appreciated between the variables ADA and ACDA, this does not suppose a problem in our study because they are never included in the same regression model. Additionally, since there are some correlation values higher than 0.4, we include a formal test to ensure that multicollinearity is not a problem in our models. Specifically, we calculate the Variance Inflation Factor (VIF) for each independent variable included in the estimated models. Since the highest VIF value is 2.8, we can conclude that multicollinearity is not a problem in our regressions (Studenmund, 1997).

Table 1. Related party transactions

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
RPTs (billons of €)	12.7	43	50.4	19.7	26.2	33.8	33.1	45.9	38.1	21.4	30.4
Percentage of assets	4.27	11.91	10.01	3.16	3.91	4.97	4.37	6.07	5.14	3.02	4.48

Table 2. Panel A. Descriptive statistic

Variables	Average	SD	Median	Min	Max
ADA	0.10	0.11	0.08	0,00	0.75
ACDA	0.08	0.10	0,05	0.00	0.66
RPTs	0.03	0.08	0.00	0.00	0.49
BIG4	0.91	0.29	1.00	0.00	1.00
LOSS	0.22	0.41	0.00	0.00	1.00
LEV	0.68	0.23	0.68	0.20	1.66
MKBOOK	2.58	3.49	1.66	-2.29	22.87
ABDIF	3.36	12.45	0.50	0.01	97.52
SIZE	13.32	1.92	13.18	8.98	18.52
ROA	0.02	0.10	0.03	-0.40	0.32
DIVERG	3.83	6.65	0.00	0.00	27.92

Panel B. Correlation matrix

	ADA	ACDA	RPTs	BIG4	LOSS	LEV	MKBOOK	ABDIF	SIZE	ROA	FIV
ACDA	0.85***										
RPTs	0.09***	0.09***									1.03
BIG4	-0.08**	-0.11***	-0.05								1.13
LOSS	-0.01	0.04	0.03	-0.12***							2.09
LEV	0.09***	0.14***	0.03	-0.04	0.30***						1.67
MKBOOK	0.13***	0.07**	0.02	0.03	0.13***	0.02					1.16
ABDIF	-0.00	-0.01	-0.01	-0.06	0.31***	0.03	0.11***				1.16
SIZE	-0.06*	-0.10***	0.12***	0.26***	-0.15***	0.29***	0.01	-0.05			1.53
ROA	-0.03	-0.08**	0.01	0.17***	-0.68***	-0.43***	0.30***	-0.30***	0.09***		2.84
DIVERG	0.04	0.03	0.08**	-0.00	0.01	0.04	-0.04	0.04	0.09***	0.02	1.03

4.2. Related party transactions and earnings management

We estimate all of the regressions using a panel data procedure: generalized method of moments (GMM) developed by Arellano and Bond (1991), adding the corrections proposed by Arellano and Bover (1995) and Blundell and Bond (1998). This procedure is robust to some sources of endogeneity (simultaneity and heterogeneity)[1].

Thus, to test our hypothesis, we estimate the following regression models:

$$ADA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \alpha_6 ABDIF_{it} + \\ + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (1)$$

$$ACDA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \alpha_6 ABDIF_{it} + \\ + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (2)$$

Table 3 (Model 1 and 2) shows a positive effect of RPTs on earnings management (α_1 = 0.250 Model 1 and α_1 = 0.220 Model 2). These results are consistent with the opportunistic perspective according to which controlling shareholders manage earnings to avoid the adverse consequences of their self-dealing behavior. Alternatively, these results are also consistent with the alignment perspective, according to which controlling shareholders manage earnings to signal private information regarding the value-enhancing nature of RPTs.

Concerning the control variables, BIG4, disclosure of losses, and ROA (in this case, only for our second measure of earnings management) show negative effects on earnings management: while DIVERG, MKBOOK, ABDIF and LEV show positive effects on earnings management.

Finally, we conduct three Wald tests, specifically, a Wald test of the joint significance of the reported coefficients (z1), a Wald test of the joint significance of the time dummies (z2) and a Wald test of the joint significance of the industry dummies (z3). In all the tests the null hypothesis of joint significance is rejected.

4.3. Sensitivity and further analysis

In order to provide robustness to our results and in line with the previous literature (Kolhbeck y Mayhew, 2010; 2017) we substitute our continuous dependent variable (RPTs) by a dummy variable (RPTs_DIC), which takes the value of 1 if the firm discloses

[1] See Bona Sánchez *et al.* (2014) for a more comprehensive description of the GMM estimator.

any RPTs, and 0 otherwise. Thus, Table 4 (Model 3 and 4) shows results consistent with our previous models.

Table 3. RPTs and earnings management

Model 1:

$$ADA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \\ + \alpha_6 ABDIF_{it} + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

Model 2:

$$ACDA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \\ + \alpha_6 ABDIF_{it} + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

	Model 1	Model 2
RPTs$_{it}$	0.250***	0.220***
	(3.11)	(2.77)
BIG4$_{it}$	-0.054**	-0.093***
	(-2.11)	(-2.82)
DIVERG$_{it}$	0.002***	0.002*
	(2.80)	(1.89)
LOSS$_{it}$	-0.102***	-0.080***
	(-3.88)	(-3.43)
MKBOOK$_{it}$	0.006***	0.008***
	(2.76)	(3.55)
ABDIF$_{it}$	0.001***	0.001**
	(3.04)	(2.24)
LEV$_{it}$	0.070**	0.109***
	(2.46)	(3.37)
SIZE$_{it}$	-0.001	0.000
	(-0.15)	(0.04)
ROA$_{it}$	-0.090	-0.135*
	(-0.87)	(-1.95)
Constant	0.029	0.021
	(0.37)	(0.19)
Year effect	*Yes*	*Yes*
Industry effect	*Yes*	*Yes*
Hansen	34.23	31.66
	(0.553)	(0.792)
m2 test	-1.46	-0.52
	(0.145)	(0.603)
z1 test	6.44***	10.64***
z2 test	1.89*	1.89*
z3 test	16.61***	3.76***

***,**,*: Statistically significant at p .01, p .05 and p .10, respectively.
In parentheses, t-statistics based on robust standard errors.

We have provided two alternative explanations to explain the positive relation between RPTs and earnings management. Thus, according to the value enhancing perspective, RPTs are efficient transactions, which benefit all shareholders and in such a setting, controlling shareholders might engage in earnings management to reduce information asymmetries and signal the market their private information. However, according to the opportunistic perspective, RPTs could also be driven by the controlling shareholders' opportunism. In such a case, controlling shareholders may increase their incentives to

Table 4. Sensitivity Analysis. RPTs and earnings management.

Model 3:

$$ADA_{it} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \\ + \alpha_6 ABDIF_{it} + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

Model 4:

$$ACDA_{it} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 BIG4_{it} + \alpha_3 DIVERG_{it} + \alpha_4 LOSS_{it} + \alpha_5 MKBOOK_{it} + \\ + \alpha_6 ABDIF_{it} + \alpha_7 LEV_{it} + \alpha_8 SIZE_{it} + \alpha_9 ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

	Model 3	Model 4
RPTs_DIC$_{it}$	0.038*	0.029**
	(1.79)	(2.32)
BIG4$_{it}$	-0.089**	0.003
	(-2.29)	(0.14)
DIVERG$_{it}$	0.002**	0.000
	(2.15)	(0.47)
LOSS$_{it}$	-0.036*	-0.025*
	(-1.68)	(-1.77)
MKBOOK$_{it}$	0.004*	0.006***
	(1.88)	(3.98)
ABDIF$_{it}$	-0.000	0.000
	(-0.63)	(0.28)
LEV$_{it}$	-0.033	0.095***
	(-0.84)	(3.50)
SIZE$_{it}$	-0.003	0.003
	(-0.49)	(0.87)
ROA$_{it}$	-0.290	-0.004
	(-0.38)	(-0.08)
Constant	0.161	-0.095
	(1.63)	(-1.31)
Year effect	*Yes*	*Yes*
Industry effect	*Yes*	*Yes*
Hansen	35.38	42.80
	(0.403)	(0.480)
m2 test	-1.53	-0.66
	(0.126)	(0.509)
z1 test	3.48***	5.44***
z2 test	1.74*	4.28***
z3 test	8.20***	9.89***

***,**,*: Statistically significant at p .01, p .05, and p .10. respectively.
In parentheses, t-statistics based on robust standard errors.

manage earnings in order to conceal the opportunistic use of RPTs. Thus, to provide some light on these alternative explanations, we focus on the role of discretionary

accruals (DA) in predicting future cash flows (OCF) in the presence of RPTs. Thus, the presence of a negative relationship between DA and OCF in firms engaging in RPTs may indicate that earnings management is induced by the controlling shareholder's opportunism. Thus, we test the following regression models:

$$OCF_{it+1} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 DA_{it} + \alpha_3 RPTs\_DIC_{it} * DA_{it} + \alpha_4 NA_{it} + \alpha_5 RPTs\_DIC_{it} * NA_{it} + \alpha_6 OCF_{it} + \\ + \alpha_7 RPTs\_DIC_{it} * OCF_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (3)$$

$$OCF_{it+1} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 CDA_{it} + \alpha_3 RPTs\_DIC_{it} * CDA_{it} + \alpha_4 CNA_{it} + \alpha_5 RPTs\_DIC_{it} * CNA_{it} + \alpha_6 OCF_{it} + \\ + \alpha_7 RPTs\_DIC_{it} * OCF_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (4)$$

where CDA are current discretional accruals; NA are normal accruals; CNA are current normal accruals; and η_k and λ_j control for industry and year effects, respectively.

As shown in Table 5 (Models 5 and 6), we find that earnings management negatively affects future cash flows in firms engaging in RPTs (α_3 = -3.955 Model 5 and α_3 = -3.941 Model 6). Thus, in a context where listed firms give priority to business over state goals, we show that controlling shareholders engage in RPTs for opportunistic reasons and decrease the quality of accounting information to conceal the opportunistic use of RPTs.

Table 5. The effect of earnings management on future cash flows in firms engaging in RPTs.

Model 5:

$$OCF_{it+1} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 DA_{it} + \alpha_3 RPTs\_DIC_{it} * DA_{it} + \alpha_4 NA_{it} + \alpha_5 RPTs\_DIC_{it} * NA_{it} + \alpha_6 OCF_{it} + \\ + \alpha_7 RPTs\_DIC_{it} * OCF_{it} + \eta_k + \lambda_j + \varepsilon_i$$

Model 6:

$$OCF_{it+1} = \alpha_o + \alpha_1 RPTs\_DIC_{it} + \alpha_2 CDA_{it} + \alpha_3 RPTs\_DIC_{it} * CDA_{it} + \alpha_4 CNA_{it} + \alpha_5 RPTs\_DIC_{it} * CNA_{it} + \alpha_6 OCF_{it} + \\ + \alpha_7 RPTs\_DIC_{it} * OCF_{it} + \eta_k + \lambda_j + \varepsilon_i$$

	Model 5	Model 6
RPTs_DIC$_{it}$	-0.213**	-0.161*
	(-2.45)	(-1.92)
DA$_{it}$	3.487***	
	(12.08)	
CDA$_{it}$		3.467***
		(10.14)
*RPTs_DIC$_{it}$*DA$_{it}$*	-3.955**	
	(-11.62)	
*RPTs_DIC$_{it}$*CDA$_{it}$*		-3.941***
		(-9.04)
NA$_{it}$	1.636***	
	(4.72)	
CNA$_{it}$		1.262***
		(2.68)
*RPTs_DIC$_{it}$*NA$_{it}$*	-1.505***	
	(-3.08)	
*RPTs_DIC$_{it}$*CNA$_{it\ it}$*		-1.300**

		(-2.06)
CFO_{it}	0.153***	0.250***
	(4.28)	(5.14)
$RPTs\_DIC_{it}*CFO_{it}$	-0.135**	-0.226***
	(-2.42)	(-2.83)
Constant	0.234***	0.186**
	(3.37)	(2.02)
Year effect	*Yes*	*Yes*
Industry effect	*Yes*	*Yes*
Hansen	50.14	30.12
	(0.109)	(0.511)
m2 test	-0.16	-0.21
	(0.876)	(0.832)
z1 test	113.97***	78.89***
z2 test	12.71	8.22***
z3 test	7.55***	3.79***

***,**,*: Statistically significant at p .01, p .05 and p .10, respectively.
In parentheses, t-statistics based on robust standard errors

In the Spanish context, the promotion of the best practices for audit committees of public interest companies constitutes a priority of the CNMV agenda (KPMG, 2017). Therefore, we analyze if an audit committee which meets the best audit committee guidelines mitigates the positive relation between RPTs and earnings management. Unlike previous studies, we do not focus on the audit committee existence, or on some audit committees' features in isolation, such as audit committees' independence, size, financial expertise or meeting frequency (*e.g*., Klein, 2002; Bédard, Chtourou and Courteau, 2004; Davidson *et al*., 2005; Piot and Janin, 2007; Baxter and Cotter, 2009; Ghosh, Marra, and Moon, 2010; Kent, Routledge, and Stewart, 2010; Lo, Wong, and Firth, 2010). On the contrary, we adopt a wider perspective by focusing on the audit committee compliance with the recommendations of the existing good governance code. This approach allows us to consider some additional and relevant dimensions of the audit committee function, such as those related to the internal control and risk management, often omitted in the previous literature.

In this sense, in the Spanish context, good governance codes have undergone several amendments during the last years. The last version emphasizes the monitoring role of the audit committee (CNMV, 2015). Additionally, the CNMV has issued some technical guidance, including principles, recommendations and criteria for the proper performance of the audit committee's functions (CNMV, 2017). These initiatives reveal Spanish regulators' concerns about the effectiveness of this supervisory body.

Thus, we collect the data related to the audit committee compliance with the good governance code's recommendations from the firms' annual corporate governance report. In this sense, our database begins in 2007, because during this year the Circular

4/2007 of the CNMV, which modifies the annual corporate governance report of listed firms, comes into force. This code unifies the recommendations of the previous codes and provides more consistent information.

In this way, the unified code of good governance includes 58 recommendations grouped in four different categories: (1) bylaws and general shareholders' meeting, (2) board of directors (3) on directors, and (4) on committees. The last category compiles recommendations related to the audit committee. Specifically, there are eight recommendations (from 46 to 53 for the period 2007- 2012 and from 41 to 48 for the period 2013-2014). The recommendations were renumbered due to an updating of the code in 2013. Thus, we create a dummy variable (COMP) that takes the value of 1 if the audit committee complies with all the recommendations related to the audit committee, and 0 otherwise.

To analyze the moderating role of the audit committee we run the following regression:

$$ADA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 COMP_{it} + \alpha_3 RPTs_{it} * COMP_{it} + \alpha_4 BIG4_{it} + \alpha_5 DIVERG_{it} + \alpha_6 LOSS_{it} + \\ + \alpha_7 MKBOOK_{it} + \alpha_8 ABDIF_{it} + \alpha_9 LEV_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} ROA_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (5)$$

$$ACDA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 COMP_{it} + \alpha_3 RPTs_{it} * COMP_{it} + \alpha_4 BIG4_{it} + \alpha_5 DIVERG_{it} + \alpha_6 LOSS_{it} + \\ + \alpha_7 MKBOOK_{it} + \alpha_8 ABDIF_{it} + \alpha_9 LEV_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} ROA_{it} + \eta_k + \lambda_j + \varepsilon_i \quad (6)$$

The results are shown on Table 6 (Model 7 and 8). Our results reveal a positive relationship between RPTs and earnings management (α_1 = 0.721 in Model 7 and α_1 = 0.381 in Model 8). Moreover, an audit committee that complies with the recommendations of the code of good governance mitigates this positive relation, since the coefficient of the interacting variable (RPTs*COMP) is negative and statistically significant (α_3 = -0.523 in the Model 7 and α_3 = -0.318 in the Model 8). Therefore, our results suggest that an audit committee that complies with the recommendations of the code is an effective corporate governance mechanism in constraining opportunistic earnings management related to RPTs.

Table 6. RPTs and earnings management. The moderating effect of the audit committee

Model 7:

$$ADA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 COMP_{it} + \alpha_3 RPTs_{it} * COMP_{it} + \alpha_4 BIG4_{it} + \alpha_5 DIVERG_{it} + \alpha_6 LOSS_{it} + \\ + \alpha_7 MKBOOK_{it} + \alpha_8 ABDIF_{it} + \alpha_9 LEV_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

Model 8:

$$ACDA_{it} = \alpha_o + \alpha_1 RPTs_{it} + \alpha_2 COMP_{it} + \alpha_3 RPTs_{it} * COMP_{it} + \alpha_4 BIG4_{it} + \alpha_5 DIVERG_{it} + \alpha_6 LOSS_{it} + \\ + \alpha_7 MKBOOK_{it} + \alpha_8 ABDIF_{it} + \alpha_9 LEV_{it} + \alpha_{10} SIZE_{it} + \alpha_{11} ROA_{it} + \eta_k + \lambda_j + \varepsilon_i$$

	Model 7	Model 8
$RPTs_{it}$	0.721***	0.381***
	(2.68)	(3.35)
$COMP_{it}$	-0.025	-0.043***
	(-1.39)	(-2.89)
$RPTs_{it}*COMP_{it}$	-0.523*	-0.318*
	(-1.71)	(-1.87)
$BIG4_{it}$	0.006	-0.105**
	(0.25)	(-2.60)
$DIVERG_{it}$	0.003***	0.001
	(3.08)	(1.15)
$LOSS_{it}$	-0.074***	-0.075***
	(-3.07)	(-5.25)
$MKBOOK_{it}$	0.004	0.008***
	(1.52)	(3.34)
$ABDIF_{it}$	0.001***	-0.000
	(3.22)	(-0.38)
LEV_{it}	-0.009	0.064**
	(-0.22)	(2.29)
$SIZE_{it}$	-0.010	0.004
	(-1.74)	(1.04)
ROA_{it}	-0.149**	-0.186***
	(-2.16)	(-3.00)
Constant	0.203*	0.074
	(1.83)	(0.76)
Year effect	*Yes*	*Yes*
Industry effect	*Yes*	*Yes*
Hansen	38.96	44.31
	(0.257)	(0.543)
m2 test	0.04	0.88
	(0.971)	(0.381)
z1 test	12.06***	15.92***
z2 test	2.28*	4.56***
z3 test	4.55***	3.01**

***,**,*: Statistically significant at p .01, p .05 and p .10, respectively.
In parentheses, t-statistics based on robust standard errors

5. CONCLUSIONS

Major accounting scandals in the last decades have raised concern about RPTs and particularly about their effect on financial reporting and audit policies. However, the literature that investigates the relation between RPTs and earnings management is scarce and mainly focused on East Asian countries (Aharony *et al.,* 2010; Jiang and Wong, 2010; Chen *et al*., 2011; Hwang *et al*., 2013; Shin *et al*., 2019). Moreover, some of these studies analyze earnings management though particular RPTs under specific settings. In a context characterized by weak investor protection (La Porta *et al*., 1999)

where state ownership is almost non- existent and companies are monitored by market forces, our results show a positive relation between RPTs and earnings management. Additional tests suggest that this positive relation is driven by the controlling shareholder's opportunism. Our findings differ from those of Shin *et al*., (2019) who suggest that manager's accounting choices associated to RPTs are driven by the need to convey private information on earnings potentials.

Finally, we also reveal that an audit committee, which meets the best audit quality guidelines, mitigates the positive relation between RPTs and earnings management. Thus, the compliance with the audit committee recommendations becomes an effective mechanism in constraining opportunistic earnings management related to RPTs.

We contribute to the previous literature in different ways. First, we provide novel empirical evidence on the relation between RPTs and earnings management in a context where ownership of listed firms is highly concentrated in the hands of families and financial institutions and companies are monitored by market forces and not by regulators. Second, we extend the empirical evidence on the consequences of RPTs on corporate behavior and particularly on financial reporting policies. Third, we provide evidence of an important corporate governance role for an audit committee that meets the best audit committee guidelines in constraining opportunistic earnings management associated to RPTs.

Our study has important implications for investors and policy makers by showing that in Continental Europe, RPTs reduce financial reporting quality, which may affect the efficient allocation of resources by the economic system. Thus, to restore market confidence by increasing transparency, regulators should pay close attention to firms engaging in RPTs. Furthermore, the moderating effect of an audit committee which meets the best audit committee guidelines for the positive relation between RPTs and earnings management is also a relevant finding for the aforementioned stakeholders and provide empirical support to the recent regulatory initiatives aimed at strengthening the role of the audit committee in corporate governance and particularly in enhancing transparency.

This paper suggests several avenues for future research. Thus, it could be interesting to analyze if the different categories of RPTs might have the same effect on earnings management or if other relevant corporate governance mechanisms might have any effect on the relation between RPTs and earnings management. We leave these issues for future research.

APPENDIX

VARIABLE	DEFENITION
ADA_{it}	Absolut value of the discretionary accruals
$ACDA_{it}$	Absolut value of the current discretionary accruals
DA_{it}	Discretionary accruals
CDA_{it}	Current discretionary accruals
NA_{it}	Normal accruals
CNA_{it}	Current normal accruals
$RPTs_{it}$	Monetary value of the transactions between the firm and its main shareholders, directors and managers divided by total assets
ROA	Income before interest and taxes divided by total assets
RPT_DIC_{it}	Dummy variable that takes the value of 1 if the firm disclosures at least one RPTs during the year, and 0 otherwise
OCF_{it}	Operating cash flow scaled by total assets
$BIG4_{it}$	Dummy variable that takes the value of 1 if the firm is audited by Deloitte, Price Waterhouse Cooper, Ernst &Young or KPMG, and 0 otherwise
$LOSS_{it}$	Dummy variable that takes the value of 1 if net income is negative, and 0 otherwise
LEV_{it}	Total debt in year t divided by total assets at the beginning of year t
$ABDIF_{it}$	The absolute value of the change in net income between years t−1 and t
$MKBOOK_{it}$	The market value of equity divided by the book value of shareholder
$SIZE_{it}$	The natural logarithm of the market value of equity
$DIVERG_{it}$	Degree of divergence between the dominant owner's voting and cash flow rights
$COMP_{it}$	Dummy variable that take the value of 1 if audit committee comply with all recommendations of the code of good governance related to the audit committee and 0 otherwise

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