Related-party transactions: a review of the regulation, governance and auditing literature

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Abstract

Purpose – Several studies, especially in Asian economies, have investigated the antecedents, implications and consequences of related-party transactions (RPTs). This paper aims to review this literature to collate, gauge and critically discuss understandings of the relationship between RPTs and risk, with a particular focus on audit risk.

Design/methodology/approach – The paper discusses RPTs and how they have been associated with corporate scandals and the expropriation of shareholders' wealth. RPTs are defined as per accounting standards and the main types of RPTs are described based on the extant literature. Two key research design issues are discussed: measures used to operationalize RPTs and observable variations in sample size across RPT studies. Evidence is presented on the negative effects of RPTs and the role of regulation, corporate governance and auditing in reducing risks.

Findings – Prior studies have associated RPTs with the expropriation of shareholders' wealth, declining firm valuations, lower-quality financial reporting, increased risk of material misstatements and decreases in long-term firm performance. Further, the evidence suggests that regulation, corporate governance and auditing can mitigate the negative effects of RPTs.

Practical implications – This paper provides insights for regulators on the effects of enforcement, corporate governance and external audits on reducing the negative effects of RPTs, and highlights the increased risk of material misstatements in financial statements when RPTs are conducted. Moreover, it reveals how RPTs affect risk assessments for auditors.

Originality/value – This paper represents the first comprehensive review of the empirical RPT literature. It provides a starting point for future investigations of RPTs, not least because it reveals important limitations with the extant body of research in this domain. It also offers salient insights and implications for practitioners and policy makers.

Keywords Literature review, Corporate governance, Auditing, Related party transactions

Paper type Literature review

1. Introduction

Related-party transactions (RPTs) are a potential means for insiders to expropriate shareholders and other investors/lenders (Ryngaert and Thomas, 2012). RPTs have been directly associated with financial scandals, fraud and decreased earnings quality (Ge *et al.*, 2010). They provide direct opportunities for managers, directors and related parties (RPs) to extract resources from minority shareholders (Djankov *et al.*, 2008; Johnson *et al.*, 2000). However, although RPTs are too often used by controlling shareholders for their own self-interest, not all RPTs are designed or adopted for expropriation, and it has been reported that a sizable proportion of RPTs are conducted solely for business/commercial purposes as they can be used to improve asset utilization and resource allocation (Gordon *et al.*, 2004; Ryngaert and Thomas, 2012; Henry *et al.*, 2012; Jia *et al.*, 2013).

Managerial Auditing Journal
Vol. 33 No. 8/9, 2018
pp. 779-806

0268-6902
DOI 10.1108/MAJ-07-2017-1602

Reviewing the literature on RPTs with the objective of assessing what has been learned from existing studies is of inherent interest to auditing researchers and practitioners due to the association between RPTs and audit risks. Research and practice have shown that auditing RPTs is problematic. For example, the American Institute of Certified Public Accountants (AICPA) has acknowledged RPTs as unquestionably difficult to audit (AICPA, 2001). This view is supported by empirical evidence that RPTs are among the top ten most commonly identified audit deficiencies in Securities and Exchange Commission (SEC) fraud-related enforcement actions (Beasley *et al.*, 2000). Therefore, this study reviews the literature on RPTs, focusing on the auditing of RPTs and the audit risks associated with these transactions. The review also endeavors to shed light on the role of external auditing and other monitoring mechanisms, namely, country-level specific RPTs and corporate governance in reducing the negative effects of opportunistic RPTs. That subset of the relevant empirical literature which explores when and where RPTs are conducted for efficient contracting purposes (or at least for motives that are not explicitly fraudulent or manipulative in nature) is also reviewed.

While Gordon *et al.* (2007) provided a review focused on RPTs published up to 2006, there are three important differences between that existing work and the review presented herein.

First, Gordon *et al.* (2007) reviewed studies related only to the auditing of RPTs, without considering those studies that have investigated other, non-auditing, consequences of RPTs or the determinants of these transactions. Research has associated RPTs with several corporate scandals. Such scandals have brought attention to the potential for accounting manipulations associated with RPTs to reduce earnings quality (Ge *et al.*, 2010). Djankov *et al.* (2008) argued that RPTs may provide direct opportunities for RPs to extract cash from listed companies (Johnson *et al.*, 2000). Gordon and Henry (2005), Cheung *et al.* (2006, 2009a,b), Berkman *et al.* (2009), Chen *et al.* (2009a, 2009b), Ge *et al.* (2010), Lei and Song (2011), and others have all found a significant relationship between the presence and volume of RPTs and inflated earnings, decreasing minority shareholder wealth, declines in firm value, and negative excess returns. Therefore, it is important to survey empirical studies that have investigated the effects of RPTs to fully understand their complexity. In addition, as discussed in this review, several studies have investigated the effect of auditing and corporate governance, as firm-level controls, on RPTs. Therefore, reviewing the findings of these studies will enhance knowledge about control mechanisms that could be capable of mitigating the negative effects of RPTs on shareholders' wealth and firm value.

Second, the review by Gordon *et al.* (2007) did not include any studies outside of the USA. Since 2007, research on RPTs has significantly increased due to their relationship with various accounting irregularities. Consequently, several studies have investigated the effect of RPTs on different attributes, such as shareholders' wealth, firm value and financial performance. More importantly, several studies have investigated the efficacy of country-level regulations related to RPTs in reducing the negative effects of RPTs. Therefore, accumulating evidence on RPTs from different countries which are heterogeneous in terms of regulation, enforcement, investor protection and ownership concentration will provide a better understanding and clearer insights about the nature of RPTs and how regulation and other types of intervention can reduce the negative effects of RPTs.

Third, Gordon *et al.* (2007) reviewed studies related to the auditing of RPTs that were published in or before 2006. Therefore, this review extends the literature on RPTs by considering all RPT-related studies published up to 2017 to comprehensively gauge and explore the state-of-the-art.

Moreover, thoroughly reviewing the empirical literature on RPTs provides an opportunity to explore and, thus in future, resolve some limitations in that literature. First, it is important to understand patterns in this body of research in terms of sampled countries/ firms because any disproportionate focus could limit the validity of generalizing these results. For example, research into RPTs is common in the context of Asian economies, which are often typified by highly concentrated ownership structures and concerns around controlling shareholder motivation to expropriate shareholders (Gordon and Henry, 2005). Additionally, corporate governance reforms following the Asian financial crisis in 1997 paid due attention to RPTs and created a special context for the study of these transactions in Asia (Cheung *et al.*, 2006). Thus, inferences from those studies may not necessarily apply to other markets (Gordon and Henry, 2005). Second, there are two opposing theoretical frameworks concerning RPTs in prior studies. The first theory, known as efficient contracting, argues that RPTs can be used to optimize internal resource allocation and reduce transaction costs; the second theory, known as agency theory, argues that RPTs can be used to expropriate by tunneling resources from listed firms (Chang and Hong, 2000). Therefore, one objective of this review is to compile evidence on RPTs to identify which of these standpoints is supported by the empirical studies conducted so far.

It might be considered surprising that RPTs have not received the same level of attention from researchers in the USA, given concerns over the presence of suspicious RPTs in recent high-profile accounting fraud scandals such as Enron, Adelphia, WorldCom and Tyco (Gordon *et al.*, 2007), nor in Europe, despite scandals including Rundenwerke, Parmalat and Bremer Vulkan (Bennouri *et al.*, 2011). Nevertheless, the unveiling of accounting scandals related to RPTs in European countries and the US shows that this area of research is important and relevant around the world, not just in Asian countries, which have thus far been the principal focus of research into RPTs.

The remainder of this review is structured as follows. Section 2 defines RPTs and expands on the two theoretical motivations underlying their use and proliferation. Section 3 provides a brief discussion about the auditing of RPTs. This includes the history of auditing RPTs, how RPTs are related to audit risks and the negative consequences of RPTs that could heighten the exposure of auditors to the risks of reputational damage and litigation. In Section 4, the literature related to the role of external auditing and other monitoring mechanisms in curbing the negative effects of RPTs is reviewed. Section 5 reviews the subset of evidence that shows that not all RPTs are negative with some types of RPTs being conducted for efficient contracting purposes in certain cases. Section 6 illuminates key research design issues that are important in the RPTs context. In Section 7, several suggestions for future research related to RPTs are delineated. Finally, Section 8 summarizes and concludes the paper.

2. Background

2.1 Defining related-party transactions?

According to the US GAAP Statement of Financial Accounting Standards 57 (AS 57), RPTs are transactions between a company and its subsidiaries, affiliates, principal owners, officers or their families, directors or their families, or entities owned or controlled by the company's officers or their families. The International Accounting Standards (IAS) definition of RPs is similar to how these parties are understood in AS 57: "As mentioned in paragraph 29.2, IAS 24 (revised) a RP can be a person, an entity, or an unincorporated business" (PricewaterhouseCoopers, 2010). IAS 24's definition comprises two parts: the first identifies general criteria that result in a person, or a close member of that person's family, being a RP from the perspective of the reporting entity; the second identifies the conditions that result in an entity being a RP or not.

According to Ryngaert and Thomas (2012), Jian and Wong (2010) and Cheung *et al.* (2006), transactions between listed companies and their controlling shareholders can be classified into five major types: sales and acquisitions of assets, asset swaps, sales of goods and services, direct cash payments (or loans or loan guarantees) and transactions with non-listed subsidiaries.

2.2 Motivations behind related-party transactions

Two competing views explain the economic incentives for conducting RPTs (Fang *et al.*, 2018). On one hand, the efficient contracting perspective (Kahnna and Palepu, 2000) assumes that close interactions among RPs enable them to reduce transaction costs compared to arm's length transactions. Following this view implies that RPTs could be beneficial for firm performance (Gordon and Henry, 2005; Ryngaert and Thomas, 2012), especially in emerging markets with less developed intermediary institutions (Fang *et al.*, 2018). Also, prior literature suggests that RPTs are not necessarily a mechanism for fraud and not all types of RPTs are associated with fraud cases (Henry *et al.*, 2012).

By contrast, according to the opportunistic perspective (Johnson *et al.*, 2000), RPTs provide direct opportunities for managers, directors and RPs to extract resources from minority shareholders (Djankov *et al.*, 2008; Johnson *et al.*, 2000), or represent an earnings management mechanism by which managers manipulate earnings towards desired targets (La Porta *et al.*, 2003; Jian and Wong, 2010; Lo *et al.*, 2010).

The objective of externally auditing financial statements as a control mechanism designed to mitigate agency conflicts is to protect minority shareholders from opportunistic RPTs and ensure that whenever RPTs are conducted, they are motivated by an efficient contracting intention rather than an opportunistic or manipulative intention. In this context, an assessment of what we know about the relationship between RPTs and the external audit function is warranted to better identify salient avenues for future research on the link between RPTs and auditing.

3. Auditing related-party transactions

3.1 History and development

Although not all RPTs are improper or fraudulent (Gordon and Henry, 2005; Henry *et al.*, 2012; Ryngaert and Thomas, 2012), there lies the potential for opportunistic behaviors by managers and controlling shareholders like self-dealing and shareholder wealth expropriation under the umbrella of RPTs (Kohlbeck and Mayhew, 2017). Given this potential, RPTs have always been under the regulatory spotlight of accounting oversight bodies, especially in the USA and China.

In the USA, Section 10A(a)(2) of the Securities Exchange Act 1934 requires either auditors to identify RPTs that are material to financial statements or issuing companies to disclose such transactions (Clikeman and Liu, 2017). In 1974, the SEC censured Touche Ross for deficiencies in auditing the financial statements of US Financial Inc where the client materially overstated its 1970 and 1971 net income through real estate sales to RPs. Subsequently, the AICPA issued Statement on Auditing Standards (SAS) No. 6, *Related Parties* that explicitly required auditors to identify non-arm's length transactions between clients and affiliated entities. The requirements of SAS No. 6 were codified into Accounting Update (AU) 334 in 1983.

However, years later, in 2001, accounting and auditing practices were still such that RPTs were highlighted as requiring more attention from auditors due to the inherent difficulties associated with auditing these transactions (AICPA, 2001). This was evident in the difficulties that existed in auditing RPTs in certain high-profile accounting scandals like Adelphia, Enron and Tyco. More broadly, an SEC examination between 1997 and 2003 revealed that there were several incidences where clients had failed to disclose material RPTs (SEC, 2003).

Given the persisting difficulties in auditing RPTs, the Public Company Accounting Oversight Board (PCAOB) decided to issue a new auditing standard, AS 18, *Related Parties*, which became effective for audits of financial statements from December 15, 2014. AS 18 requires auditors to provide reasonable assurance that RPTs have been properly identified, accounted for, or disclosed in financial statements. AS 18 provides guidance to auditors on how to improve their procedures for auditing RPTs (Clikeman and Liu, 2017).

3.2 Related-party transactions and audit risks

The fact that recent accounting fraud scandals, such as Adelphia, Enron, Tyco and WorldCom, were linked to RPTs raised concerns regarding RPT audit practices (Gordon *et al.*, 2007). In some cases, RPTs might be conducted for deceptive, rather than business, purposes. However, a major problem is that RPTs are difficult to audit (AICPA, 2001). For auditors, it is not straightforward to identify RPs and transactions that require examination. Moreover, the sole source of information for auditors about RPTs is the management of the auditee, and internal controls cannot easily track RPTs. This implies that difficulties related to auditing RPTs could coincide with legitimate or opportunistic RPTs.

Regarding the difficulties faced with auditing RPTs, Beasley *et al.* (2001) found that RPTs are among the top ten audit deficiencies in cases of SEC fraud-related enforcement actions. They concluded that auditors are often unaware of RPs or appear to cooperate in the client's decision to obscure a transaction with this party. In another study, Beasley *et al.* (2000) revealed that impaired auditor independence was a factor in 50 per cent of cases where RPTs were named as a major audit deficiency. Perhaps unsurprisingly, and to minimize the likelihood of detection, the research synthesis on RPTs by Gordon *et al.* (2007) suggested that companies that use RPTs for fraudulent purposes are more likely to enlist the services of auditors with whom they already have a relationship.

Other studies have investigated how the presence of RPTs can impact the auditor's risk assessment of the client (Gordon *et al.*, 2007). In this vein, Apostolou *et al.* (2001) found that RPTs are considered among the less important fraud risk factors. By contrast, Wilks and Zimbelman (2004) found that the presence of RPTs that are not part of the ordinary course of business rank third most important out of six opportunity risk factors evaluated. While, Bell and Carcello (2000) found no significant difference between fraud cases and non-fraud cases when various fraud risk factors were assessed.

The findings of these studies show that in some cases, auditors might not be aware of the risks associated with RPTs or they may underestimate the challenges and risks associated with auditing RPTs. However, from a regulation and oversight perspective, the link between RPTs and audit risk is clearer.

For example, the PCAOB (2004, para. 3) defines audit risk as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." The fact that RPTs could be significantly related to audit risk is confirmed by their recommendation that auditors identify "incentives and pressures that could cause management to use RPTs or significant unusual transactions to obscure a company's financial position or operating results" (PCAOB, 2012, 4). Moreover, Auditing Standard (AS) 18 requires auditors to provide reasonable assurance that the client has accounted for or disclosed RPTs. Therefore, the difficulties associated with RPTs represented by failing to identify a RP or an auditor's underestimation of the risks associated with RPTs, could lead to the issuance of an unqualified audit opinion.

It can be argued that RPTs, although not always conducted for opportunistic intentions, represent significant risks to the auditor. Those risks are manifested in the possibility of failing to issue an unclean audit opinion for a client that conducted RPTs for manipulative or opportunistic purposes. This is supported by the findings of Habib and Muhammadi (2018) who report evidence that both types of RPTs, operating and loan-type, are associated with a longer audit report lag. This evidence indicates that in some contexts, auditors are aware of the risks and complexities related to auditing RPTs and hence need more time to complete the audit engagement.

The negative implications of RPTs on auditors are twofold. First, the risk of material misstatement and reduced quality of reported earnings could trigger significant regulatory responses such as enforcement actions and delisting from stock exchanges. This imposes a significant litigation and reputational damage risk for auditors. Second, RPTs are one of the financial reporting schemes that are connected to opportunistic behavior and fraudulent reporting (Bonner *et al.*, 1998). Prior evidence shows that auditors are more likely to be held responsible for detecting commonly occurring frauds (Bonner *et al.*, 1998). As RPTs were emphasized as a principal mechanism in several financial scandals prior to the Sarbanes–Oxley Act, RPTs that result in declined accounting quality, shareholder expropriation or that might eventually diminish firm value or minority shareholders' wealth could represent significant risks to auditors. Given that audit firms are vulnerable to reputational damage in the case of a material misstatement (DeAngelo, 1981; Barton, 2005; Skinner and Srinivasan, 2012), and that RPTs could be associated with material misstatements (Kohlbeck and Mayhew, 2017) or financial fraud (Bonner *et al.*, 1998), in the following subsections we review empirical literature investigating the relationship between RPTs on the one hand and shareholder expropriation (tunneling and propping), accounting quality, and firm valuation and performance on the other hand.

The main argument is that whenever RPTs are associated with shareholder expropriation, declining earnings quality or declining firm value, this indicates that it is more likely that such RPTs were conducted for opportunistic purposes. However, this argument is subject to two main caveats. First, there is non-trivial evidence that cannot be ignored showing that RPTs are not always conducted for fraudulent or opportunistic purposes (Henry *et al.*, 2012; Ryngaert and Thomas, 2012; Jia *et al.*, 2013). Second, although considerable evidence has been accumulated regarding the negative effects of RPTs, in several cases this represents observed associations and does not necessarily imply causality. In other words, the extant research does not provide convincing evidence that declining earnings quality or negative firm valuations have been directly caused by RPTs. These caveats are discussed in detail in Section 7.

3.2.1 Tunneling and propping. The early agency literature focused on conflicts of interest between firms' management personnel and a diffused group of shareholders (Jensen and Meckling, 1976). However, because dispersed ownership is the exception rather than the norm in most countries, the agency problem *vis-à-vis* controlling shareholders and minority investors has been increasingly researched over the past two decades. Prior studies have identified the phenomenon of expropriating minority investors' wealth, referred to as tunneling, as one of the most significant agency problems in contemporary contexts (Johnson *et al.*, 2000). A large body of empirical evidence has shown that controlling shareholders may take advantage of minority shareholders through connected transactions (RPTs), especially in countries where legal protections for minority shareholders are weak (La Porta *et al.*, 1997, 1998, 1999, 2000; Johnson *et al.*, 2000).

Tunneling can be defined as corporate actions carried out by controlling shareholders with the objective of expropriating minority investors (Jiang *et al.*, 2010) followed by a decline in the value of minority shareholdings as a result of these specific actions (Cheung *et al.*, 2006). For example, controlling shareholders can extract cash by selling assets, goods or services to the company through RPTs. Moreover, they can transfer assets to other firms they control (Cheung *et al.*, 2006). Transactions between RPs can also be conducted so that controlling shareholders can prop up a listed firm that is in financial distress; this will maintain the firm's listing status and that firm will continue to be controlled to reap the private benefits from such control. Propping is simply used to temporarily boost the performance of the firm and does not add value to the firm in the long run (Peng *et al.*, 2011).

Several studies have investigated the relationship between RPTs and tunneling (and/or propping). It is worth noting that, as discussed by Peng *et al.* (2011), both tunneling and propping are equally opportunistic and reflect a facet of the agency problem between controlling shareholders and minority investors. Propping is driven by the desire of controlling shareholders to maintain control over the firm to tunnel (expropriate) minority investors of the listed firm in the future. The notion that RPTs can sometimes be used for propping rather than tunneling is supported by Friedman *et al.* (2003) and Jian and Wong (2010).

Based on data for Hong Kong, Cheung *et al.* (2006) found that corporate loans between listed companies and their controlling shareholders lead to the expropriation of minority shareholders. In another study, which used a sample of transactions between Chinese listed firms and their controlling shareholders during 2001-2002, Cheung *et al.* (2009a) reported negative cumulative abnormal returns at the announcement of RP corporate loans. This provides evidence that RPTs are conducted for expropriation purposes rather than efficient transaction purposes. Similarly, Berkman *et al.* (2009), using a sample of publicly traded Chinese firms, documented that firms issuing loan guarantees to RPs exhibit significantly lower returns on assets, lower dividend yields, higher leverage and lower values of Tobin's Q, and hence RP loan guarantees are associated with tunneling. Finally, Jiang *et al.* (2010) provided evidence that controlling shareholders exploited inter-corporate loans to transfer billions of Chinese yuan from hundreds of companies during 1996-2006.

Aharony *et al.* (2010) and Wan and Wong (2015) provided evidence that Chinese state-owned enterprises (SOE) expropriate minority shareholders who purchase SOE shares in an IPO. Aharony *et al.* (2010) also demonstrated an association between RPTs and pre-IPO earnings management with RPTs being used for tunneling purposes in the post-IPO period. In addition, Chen *et al.* (2011) revealed that firms' post-IPO long-term underperformance is an unintended consequence of using RPTs to prop up performance in the pre-IPO period.

The extant literature reveals several reasons why research into RPTs is more common in Asian economies. First, the phenomenon is more severe in these countries due to tendencies towards ownership concentration, coupled with a lack of investor protection and legal enforcement. This is important because it provides the conditions for agency problems to prevail and persist between controlling shareholders and minority investors. Second, more data on RPTs are available here compared to elsewhere in the world due to specific RPT disclosure requirements in some of those countries. For example, in China, RPTs exceeding a specific threshold must be reported to the stock exchange within two working days and a record of RPTs can be duly obtained from there. A similar requirement for disclosing RPTs exists in Hong Kong.

Collectively, albeit mainly based on studies using Chinese samples, the relationship between RPTs and tunneling is positive and significant. As discussed by Jiang *et al.* (2010), the Chinese stock market is suitable for investigating the tunneling phenomenon because all firms have a controlling shareholder and tight restrictions on the trading of controlling shares in China limit the ownership benefits to price appreciation of controlling shareholders. This, together with weak protection for minority investors and limited authority of security market regulators, incentivizes tunneling and allows it to persist.

In summary, although prior studies have shed light on the risk of expropriating minority shareholders through RPTs, whether and how the relationship between RPTs and tunneling varies in different institutional setting remains unknown. Although there is consistent evidence from prior studies conducted in China that particular RPTs are more likely to be used for tunneling purposes, whether this generalizes to other countries, characterized by more dispersed ownership structures and stronger investor protection, remains to be researched.

The limited number of studies that have investigated RPTs in Western countries such as the USA (Gordon and Henry, 2005; Kohlbeck and Mayhew, 2010, 2017) and Australia (Gallery *et al.*, 2008), have focused on investigating the association between RPTs and earnings management or corporate governance. Future research could benefit from investigating whether RPTs are associated with shareholder expropriation in these countries and the extent to which this association is mediated by prevailing institutions and legal frameworks. Another relevant issue is whether the trading of controlling shares (in countries which allow this) serves to weaken the relationship between RPTs and shareholder expropriation. Finally, it could also be fruitful for future research to explore whether all types of RPTs are associated with tunneling or the expropriation of shareholders' wealth or perhaps it is only a subset of these transactions which offer a suitable mechanism for tunneling.

3.2.2 Quality of reported earnings. The quality of reported earnings, or accounting quality, describes the extent to which reported earnings reflect the financial performance of the reporting entity (Schipper and Vincent, 2003). Previous studies have provided empirical evidence that RPTs are used to manage earnings for financial reporting and tax purposes (Lo and Wong, 2011). Moreover, controlling shareholders can use RPTs to reap private benefits at the cost of minority shareholders (Cheung *et al.*, 2006; Dow and McGuire, 2009). For insiders and managers to retain private control of benefits, they need to conceal those benefits (Leuz *et al.*, 2003). A controlling party can appropriate value for him- or herself only when this value is not verifiable, otherwise minority shareholders can provide evidence of appropriation and take legal action (Dyck and Zingales, 2004). Hence, insiders and managers use their discretion over financial reporting for their own benefit (Leuz *et al.*, 2003). Therefore, if insiders and managers have an incentive to conceal their private benefits, this will affect the informativeness of financial statements and disclosures.

Empirical evidence on RPTs supports the argument that if RPTs are used as a tool for earnings manipulation, the quality of financial statements and disclosures will decrease. For example, Hwang *et al.* (2013) found a positive association between RPTs and earnings management as measured by discretionary abnormal accruals in China and showed that this relationship was mitigated following enactment of disclosure regulation in November 2000. Again, in China, Lo and Wong (2011) provided evidence that firms that engage in RPTs and have incentives to manage earnings are less likely to voluntarily disclose the pricing methods of purchasing/selling of raw materials, goods, and services from/to RPs. Similarly, Ge *et al.* (2010) demonstrated that firms conducting RPTs exhibit lower value relevance for their financial statements. Thomas *et al.* (2004) provided early evidence that Japanese firms can manage their reported earnings not only through discretionary accruals but also through RPTs. Similarly, Chen *et al.* (2009a, 2009b) showed that RPTs can be considered as a portfolio of earnings management tools that are partly accrual based and partly cash based. Finally, Cheung *et al.* (2009a) found that RPTs conducted for expropriation purposes are accompanied by significantly less information disclosure in Hong Kong. They found evidence of expropriation by examining the valuation effects of these RPTs, which appeared to be negatively affecting cumulative abnormal returns. In South Korea, Lee *et al.* (2016) found that RPTs reduce the comparability of financial statements regardless of whether RPTs are measured in terms of their size, volatility, or whether only non-cash RPTs are considered.

In the US, Henry *et al.* (2004) demonstrated that some types of RPTs have been associated with accounting misstatements, while Gordon and Henry (2005) found that earnings management measured by adjusted absolute normal accruals is positively associated with RPTs. More recent evidence provided by Kohlbeck and Mayhew (2017) showed that RPTs are associated with restatements in the USA. By contrast, El-Helaly (2016) revealed no significant association between RPTs and various earnings management proxies for firms listed on the Athens Stock Exchange.

Taken together, the empirical literature suggests that RPTs are usually associated with lower earnings quality and misstatements. However, there is still plenty of scope for future research to investigate this with respect to a wider array of countries given the heterogeneities that exist in terms of capital market incentives for earnings management, regulations, enforcement and oversight regarding financial reporting, litigation risks for auditors and firms with respect to earnings management, and other institutional factors that could plausibly influence the relationship between RPTs and earnings management.

Additionally, there is currently insufficient evidence to conclude that RPTs associated with lower earnings quality are conducted for opportunistic purposes rather than efficient contracting incentives. To address this issue, future research could benefit from identifying and exploring the types of RPTs that are associated with lower earnings quality (Jorgensen and Morely, 2017).

3.2.3 Firm valuation and performance. Jensen and Meckling (1976) showed that when a manager owns less than 100 per cent of the firm he or she does not bear the full cost of any opportunistic consumption of corporate assets. Consequently, according to Kohlbeck and Mayhew (2010), the benefits of RPTs to managers and other insiders will outweigh their costs.

Jensen and Meckling (1976) assumed that investors anticipate this consumption and price-protect against it (Kohlbeck and Mayhew, 2010); therefore, insiders and managers will seek to avoid RPTs or adapt monitoring mechanisms so as not to incur the negative market implications of RPTs. However, when contracting is costly and managers own less than 100 per cent of a firm there might be an equilibrium of manager opportunism and investor price protection. In this case, managers benefit from RPTs and investors protect themselves against the consequences of expropriation of firm resources, and this equilibrium will generate negative market valuations (Kohlbeck and Mayhew, 2010).

Scholars have explored the valuation effects of RPTs. In sum, firms that conduct RPTs experience a reduction in firm value. For example, Cheung *et al.* (2009a, 2009b), Lei and Song (2011) and Peng *et al.* (2011) reported a negative association between RPTs and cumulative abnormal returns, and Ge *et al.* (2010) found that RPTs have negative effects on stock price. Comparable results were found in Hong Kong by Cheung *et al.* (2006). Wong *et al.* (2015) investigated the effect of RPTs on firm value, and found that although, on average, RP sales increase firm value, this value enhancement disappears in the presence of a significant proportion of parent directors, high government ownership, tax avoidance incentives and management's rent extraction activities. In summary, the findings of Wong *et al.* (2015) demonstrate the opportunistic use of RP sales.

In the USA, Gordon *et al.* (2004) highlighted the negative association between RPTs and industry-adjusted returns, while Ryngaert and Thomas (2012) found that RPTs are associated with declining share prices and a higher likelihood of firms becoming financially distressed or deregistering their securities.

Similarly, many studies have provided empirical evidence on the negative association between RPTs and Tobin's Q. Dahya *et al.* (2008) found that the occurrence of RPTs is associated with lower Qs in a sample of 799 firms across 22 countries. The negative valuation effects for firms disclosing RPTs were confirmed by Kohlbeck and Mayhew (2010) in the USA, Lei and Song (2011) in China and Nekhili and Cherif (2011) in France.

Collectively, the findings of prior studies have shown that RPTs are negatively associated with, and detrimental to, firm value. The relationship persists in different countries with significant variations in regulations, legal origin (common law vs civil law), legal enforcement, investor protection and disclosure requirements.

The literature has also shown that RPTs have a negative impact on firm performance. Although results have demonstrated that firms use RPTs to manage earnings to mask their performance prior to IPOs, these transactions are likely to have a lagged negative effect on firm performance. Chen *et al.* (2009a, 2009b) revealed that controlling shareholders in a sample of Chinese firms structured RPTs during the pre-IPO period, and that these RPTs were associated with inconsistent positive operating performance, causing long-term underperformance and negative stock returns.

Comparable results have also been provided by studies examining other types of RPTs in China. For example, Aharony *et al.* (2010) came to the same conclusion for firms engaging in RP sales of goods and services in China. Jiang *et al.* (2010) revealed significant negative economic consequences for the shareholders of Chinese firms engaging in inter-corporate loans measured by the item "other receivables" on the balance sheet. They showed that firms with high balances exhibit lower future operating performance, both in terms of lower accounting rates of return and higher likelihood of entering financial distress. Further, they showed that firms with high balances for other receivables are more likely to acquire special treatment status, which indicates that firms have had two consecutive annual losses.

Although these results seem to suggest that RPTs are characterized by conflicts of interest and information asymmetry problems, some researchers have cautioned that not all types of RPTs yield negative effects. This follows the findings of Gordon and Henry (2005), who argued that not all types of RPTs are associated with earnings management. Similarly, Ryngaert and Thomas (2012) found some RPTs to be innocuous rather than indicative of opportunistic behavior. Finally, Henry *et al.* (2012) document evidence that only some types of RPTs such as loans to RPs and unapproved payments to company officers for goods and services were prevalent in fraud cases. An explanation for the inconsistency in conclusions *vis-à-vis* the nature and extent of the negative consequences of RPTs can be drawn from a study by Jian and Wong (2010), who found that in the presence of an incentive to manage earnings, RPTs and accruals can act as substitutes. This implies that the association between RPTs and earnings management when measured using an accruals-based measure might be insignificant or even negative.

An additional problem with the RPTs literature is that, to date, there is a lack of cross-country studies available and thus disentangling the effects of national specificities, institutional factors and measurement errors on the findings of existing RPTs studies is currently difficult. Future research should also aim to identify the types of RPTs which negatively (and positively) affect firm value/performance in different country contexts and whether and the extent to which these types vary depending on prevailing legal environments and investor protection.

4. Can external auditing reduce the negative effects of related-party transactions?

This section reviews empirical studies that investigate whether external auditing as a monitoring mechanism can prevent or decrease the negative impacts on minority shareholders that could be caused by opportunistic RPTs. In several countries, RPTs are considered to be a threat to investor protection because they can be used to expropriate the wealth of minority shareholders or mask firm performance through manipulating reported earnings. Thus, the literature related to RPT regulations and how such regulations have been effective in curbing the potential consequences of opportunistic RPTs is also reviewed. Finally, another stream of literature which addresses the role of corporate governance in protecting minority investors from opportunistic RPTs is also reviewed.

4.1 External auditing

Five studies have explicitly examined the relationship between the monitoring role of external auditors and RPTs. Gao and Kling (2008) found evidence from a sample of Chinese firms that companies that have audit reports with unqualified opinions are associated with less tunneling. In France, Bennouri *et al.* (2011) showed that the reputation of the external auditor (Big 4 vs Non-Big 4) is significantly related to the number of RPTs reported to outside shareholders. They revealed that firms audited by a Big 4 audit firm report fewer RPTs. More recently, researchers have investigated the relationship between RPTs and auditor choice. Habib *et al.* (2017) found that politically connected firms in Indonesia with incentives to conceal RPT tunneling activities are less likely to appoint a Big-4 auditor. By contrast, politically connected firms with no incentives for insider trading or RPT tunneling prefer higher-quality financial reporting, and thus appoint Big-4 auditors. This finding highlights the role of external auditing in mitigating tunneling through RPTs. Again, in Indonesia, Habib and Muhammadi (2018) document evidence that auditors recognize the riskiness of RPTs and hence take more time to audit financial statements of firms that conduct RPTs, resulting in an increase in the audit report lag. Fang *et al.* (2017) show that in China, insiders of business groups that are audited by one of the big 10 auditors are more constrained from tunneling through RP lending.

Based on these studies, the relationship between external auditing and RPTs should be of interest to researchers in the future, for two reasons. First, it is currently unclear whether audit quality can explain variations in the volume of RPTs conducted in a firm, and whether this varies across different countries according to differences in institutional settings (rule of law, auditing regulations and investor protection). Second, does the relationship between RPTs and audit fees or audit report lag vary depending on the exposure of the auditor to litigation risks? If yes, then why are RPTs associated with higher audit fees in two countries with substantial differences in the strength of their national audit environment – i.e. the USA and China? More research is required to understand whether higher audit fees compensate the risks associated with auditing RPTs, and hence whether firms with more RPTs require more effort and are charged higher audit fees, or whether audit fees can impair the independence of the auditor (Beasley *et al.*, 2001).

In summary, prior research has provided convincing evidence on the association between RPTs and several audit risks. The general inference from most RPTs suggests that these transactions could be associated with material misstatements or shareholder expropriation. While it is true that RPTs are not necessarily conducted for fraudulent or opportunistic purposes, these purposes remain a significant driver of audit risk due to the potential negative impacts on auditors associated with reputational damage and litigation. Such risks are further enhanced due to the challenges related to auditing RPTs and identifying a RP as documented by prior studies and discussed in Section 3.

Further research is required to increase our understanding of the interplay between RPTs and audit risks, not least in cross-country settings. It is currently unclear whether the observed relationship between RPTs and audit risks can be generalized to countries that have relatively weak national audit environments. The national audit environment determines the strength of several variables that can influence audit risk, such as litigation risk, licensing requirements for auditors, professional development, audit oversight, and audit rotation (Brown *et al.*, 2014). Therefore, it is important to consider variations in the national audit environment when assessing the relationship between RPTs and audit risks.

4.2 Related-party transactions regulations

Prior research has shown that several regulatory actions have been pursued in different countries to mitigate the negative effects of RPTs on shareholders' wealth. One of the main reasons why RPTs have gained attention from both researchers and practitioners pertains to their use in controlling shareholders to expropriate minority shareholders. As a facet of conflicts of interest between two principals (controlling and minority shareholders), RPTs are a threat to investor protection. For this reason, one of the key issues that is taken into consideration by the World Bank in preparing its annual *Doing Business* reports is how countries protect minority investors from the negative effects associated the RPTs. This includes how RPTs are regulated and disclosed. According to the *Doing Business* website, several countries have improved how investments are protected by imposing specific regulations regarding reporting and disclosing RPTs (e.g. Albania, Armenia, Belarus, Egypt and Greece).

Therefore, the effect of investor protection and enforcement as institutional factors that can militate against the negative effects of RPTs or protect minority investors from anticipated consequences has also been addressed in prior studies. However, this remains an interesting avenue for future research. More emphasis should be put on how variations in investor protection, legal enforcement, control of corruption and disclosure regulations affect the magnitude and effects of RPTs across the globe.

Five studies have examined the effects of enforcement on RPTs; four of these used data for Chinese listed firms. This is justified by the severity of RPTs in China, as well as the relevant institutional setting, as follows. First, by heritage and design, all Chinese firms have a controlling shareholder. Second, the trading of controlling shares is highly restricted. This limits the ownership benefits of price appreciation to the controller and increases his or her incentives to seek benefits from alternative channels. Third, the legal system in China offers very few channels for minority shareholders to take enforcement actions against the opportunistic RPTs conducted by their investees. Finally, public enforcement in China is impaired due to the limited authority of security market regulators. Hence opportunistic RPTs are a well-known phenomenon in China (Jiang *et al.*, 2010).

Jiang *et al.* (2010) showed that substantive regulatory efforts in China in 2006, which aimed to resolve tunneling through intercorporate loans, had a significant positive effect on deterring this type of tunneling. Similarly, Haβ *et al.* (2016) showed that firms' tunneling mechanisms decreased significantly after the regulatory shock in 2006. They also documented that, after this shock, firms that were more likely to engage in tunneling before 2006 exhibited a significant increase in performance compared to non-tunneling firms. Finally, they provided evidence that public announcements of enforcement actions against tunneling behavior were associated with a positive market reaction.

Another event that aimed to reduce the negative effects of RPTs on minority shareholders in China was the Share Structure Reform of 2005[1]. Zhu and Zhu (2012) investigated how this reform changed the relationship between RPTs and firm value. They found that although RPTs are disadvantageous to firm valuations, the negative effect of RPTs on such valuations became less pronounced after the share structure reform in 2005.

Huyghebaert and Wang (2012) demonstrated that within Chinese listed firms, stronger regional enforcement of legislation reduced expropriation of minority shareholders through RPTs. However, this link was only observable in privately controlled firms. Gao and Kling (2008) reported a decline in tunneling in China in 2001, which they attributed to a reform that took place in that year when the government pursued the selling of state-owned stocks and improvements in corporate governance.

In 2002, legislation was introduced in Bulgaria which was effective in reducing equity tunneling and increasing the participation of minority investors in equity offerings (Atansov *et al.*, 2010).

Although all studies which have investigated the consequences of specific regulations on RPTs have shown that such regulations have a positive effect and are able to decrease the negative effects of RPTs, this body of research suffers from several limitations, and more research is warranted to improve this knowledge base. First, except for Atansov *et al.* (2010), all studies on this topic have been conducted for firms in China. While this is justified by the severity of RPTs in China, several other countries have recently acted in response to the negative effects of RPTs. For example, according to the World Bank's *Doing Business* website, several countries have improved their investment protections by imposing specific regulations regarding the reporting and disclosure of RPTs (e.g. Albania, Armenia, Belarus, Egypt and Greece among others). It is therefore worth investigating the effects of such changes, and whether they have reduced the negative effects of RPTs. Similarly, in European countries, it is important to understand whether the mandatory adoption of International Financial Reporting Standards (IFRS) in 2005[2] has had any effect on the existence, disclosure and effects of RPTs, and whether significant differences have arisen in the relationship between RPTs and various firm-level outcomes (shareholder wealth, firm value, quality of reported earnings, etc.) since 2005. In this case, IFRS adoption could be used as an exogenous shock in an inferential framework that enables assessment of causal relations, using natural experiments or difference-in-differences.

Also, in the USA, in the past decade RPTs have received considerable regulatory attention due to several salient financial scandals. Future research could benefit from investigating the effects of RPTs before and after this regulatory attention (Sarbanes-Oxley Act, PCAOB releases related to RPTs, changes in RPT disclosure requirements in US GAAP, and enforcement actions, or restatements related to RPT accounting irregularities). Finally, cross-country studies investigating the effects of RPTs, capturing international variations in the rule of law and legal enforcement, may provide a clearer understanding of the efficacy of RPT regulations and how they mitigate the negative effects of RPTs.

4.3 Corporate governance and related-party transactions

Several studies have investigated the role of corporate governance and auditors in diminishing the negative effects of RPTs on minority shareholders' wealth. Corporate governance can be defined as the set of mechanisms designed to direct and influence the decisions made by managers when there is a separation of ownership and control. The main objective of corporate governance is to ensure that the company's resources are efficiently used and that the rights of shareholders are well protected (Larcker *et al.*, 2007).

Corporate governance and controls have been shown to have a positive interaction role and can serve to reduce the use of RPTs for earnings management activities. Additionally, other studies have provided further evidence on the link between RPTs and corporate governance. For example, good corporate governance can impede opportunistic behavior of management, increase firm value and shift RPTs from conflicts of interest to efficient transactions (Dennis and McConnell, 2003; Gordon and Henry, 2005; Bhagat and Bolton, 2008; Chien and Hsu, 2010; Abdul Wahab *et al.*, 2010).

An agency theory presumption that large boards negatively impact the effectiveness of the monitoring role of the board has been leveraged to support reducing the number of board members (Jensen, 1993). Consistent with Jensen (1993), Nekhili and Cherif (2011), Kohlbeck and Mayhew (2010) and Gordon *et al.* (2004) all found that large boards are associated with more RPTs. Gordon and Henry (2004) and Balsam *et al.* (2017) argued that an increase in the number of directors is an indicator of weak governance and is associated with a higher occurrence of RPTs involving executive directors.

The negative relationship between RPTs and firm performance is supported by several studies and appears to be robust to several firm value measures, as discussed in Section 4.3. However, Chien and Hsu (2010) showed that corporate governance has a positive moderating effect on the relationship between RPTs and firm value. Similarly, Yeh *et al.* (2012) showed that corporate governance affects the magnitude of RPTs and moderates the motives for using RPTs in Taiwan. According to Yeh *et al.* (2012), the quality of corporate governance is negatively correlated with the number of RPTs, which in turn is negatively correlated with the interaction term between corporate governance and the motives for managing earnings. This indicates that even in the presence of capital market incentives to manage earnings using RPTs, corporate governance can still reduce the prevalence of RPTs for managing reported earnings. Similar conclusions on the role of governance are offered by Jian and Wong (2010), who found RPTs are used less for earnings management purposes when economic institutions are stronger.

In a cross-country study, Dahya *et al.* (2008) found that board independence is negatively associated with RPTs; thus, a higher number of independent directors reduces the likelihood of RPTs. Comparable results have been provided in China (Lo *et al.*, 2010) and Australia (Gallery *et al.*, 2008). This follows the general expectation in studying the association between board independence and RPTs – i.e. that independent directors act as more effective monitors than inside directors. Hence, board independence is expected to be negatively associated with RPTs (Chen *et al.*, 2011).

In China, Lo *et al.* (2010) investigated other governance variables and their association with RPTs. They showed that firms with a smaller proportion of directors representing the parent company are more likely to have different people occupying chair and CEO positions, have financial experts on their audit committees and are less likely to use manipulated transfer prices in RPTs.

Hu *et al.* (2012) showed that the size of cross-border RPTs is positively associated with concentrated ownership, CEO duality and an imbalance of power among large shareholders in Chinese firms. They also documented a negative association between the size of cross-border RPTs and board independence. However, they found that the role played by independent board members in reducing RPTs is constrained when the compensation for those directors increases.

Also, in China, Gao and Kling (2008) investigated the relationship between corporate governance and tunneling through RPTs. They found that board independence and dispersed ownership are associated with less tunneling. On the other hand, they reported that being a member of a business group is associated with more tunneling. In Korea, Kang *et al.* (2014) found that RPTs are associated with an ownership-control wedge. They also found that RPTs increase as voting rights increase and decrease as cash-flow rights increase.

In a US study, Balsam *et al.* (2017) showed that as insider ownership increases, so do RPTs. In France, Nekhili and Cherif (2011) demonstrated that voting rights held by the main shareholders are positively associated with RPTs, because voting rights provide expropriation opportunities to the main shareholders through RPTs. However, they found no evidence for a relationship between RPTs and the extent of ownership-control separation or business group affiliation.

Taken together, the empirical results in these studies concerning the relationship between RPTs and corporate governance yield three main insights. First, there is strong evidence that RPTs are associated with weak corporate governance. Second, although in most cases, RPTs have a negative effect on firm performance, corporate governance as a monitoring mechanism can moderate the relationship. In theory, one may expect that RPTs create incentives for controlling shareholders to expropriate minority shareholder wealth. However, in the presence of strong corporate governance only RPTs that are presumed to have positive effects on the firm's performance (efficient RPTs) will be conducted. Therefore, corporate governance mechanisms can diminish the negative influence of RPTs on firm value and performance. Finally, RPTs are associated with the power possessed by controlling shareholders, such as insider ownership, voting rights and the ability to influence independent board members by increasing their compensation.

Despite the substantial number of studies conducted in this stream, several questions remain unanswered. First, given the endogenous nature of firms' governance choices, how do legislative and regulatory changes pertaining to corporate governance affect RPTs, and does the introduction of new regulations related to RPTs reduce the negative effects of RPTs? Second, given observable differences in institutional settings across different countries, and empirical evidence that such settings significantly impact various accounting-related outcomes, future research should investigate how the level of power possessed by controlling shareholders influences the number and nature (legitimate versus opportunistic) of RPTs conducted by firms in different countries.

5. Are all related-party transactions negative?

Several studies highlight the negative consequences of RPTs. However, not everyone agrees that RPTs are always negative or indicative of fraudulent and opportunistic reporting. Indeed, certain types of RPTs are less likely to be conducted for opportunistic purposes, with evidence pointing to different contexts and cases where RPTs took place which were not disadvantageous to companies.

Henry *et al.* (2012) find evidence that the link between RPTs and fraudulent financial reporting is overestimated as some researchers do not distinguish between fraudulent cases associated with RPTs related to misappropriation of assets or shareholder expropriation from other fraudulent cases that only involve failure to disclose RPTs. While avoiding RPTs disclosure raises red flags about the intention of such transactions, firms may also decide not to disclose RPTs to avoid negative valuations (Kohlbeck and Mayhew, 2010). Henry *et al.* (2012) also show that only some types of RPTs featured in fraudulent cases. Those transactions were mainly related to unauthorized payments to company officers in exchange for goods and services and loans to RPs. Bailey (2016) highlights that loans to RPs, sales significantly different from market prices and purchases significantly different from market prices are more likely to involve fraudulent financial reporting, but not all RPTs. This is supported by the findings of Jian and Wong (2010) showing that the levels of related sales are abnormally high when firms have incentives to manage earnings.

Prior studies suggest that operating RPTs are more likely to be conducted for efficient contracting purposes, while financing RPTs are more likely to be conducted for opportunistic purposes. For example, Habib *et al.* (2015) show that audit fees are higher for RPTs that involve loans and capital transfers. This is consistent with the evidence provided by Henry *et al.* (2012), that loans to RPs were significantly related to fraudulent cases involving RPTs.

In China, Fang *et al.* (2018) show that the auditor is more likely to issue a modified audit opinion due to the existence of abnormally high related sales or related lending, but not other categories like purchases, borrowing, assets and equity transactions. Chen *et al.* (2009a, 2009b) also show that some RPTs like sales, loans, guarantees and leases have a more pronounced negative impact on operational performance than other types. Also, Ahraony *et al.* (2010) find evidence that RP sales and non-repayment of loans to RPs are used opportunistically for managing earnings. Similarly, Berkman *et al.* (2009) document evidence that guarantees to RPs negatively affect the value of Chinese firms.

Wong *et al.* (2015) show that RP sales increase the value of Chinese firms. This effect decreases as the extent of government ownership and the proportion of parent directors' increase. Finally, in a different context, El-Helaly (2016) find evidence that the total value of RPTs is not related to accounting quality for firms listed on the Athens Stock Exchange.

Collectively, this area of research could benefit from the following. First, further research investigating how different RPTs affect firm performance, shareholder expropriation and accounting quality is encouraged. Second, more in-depth research about the mechanisms through which types of RPTs could become disadvantageous to companies and whether external auditing or other monitoring mechanisms can ameliorate the negative consequences of such transactions is warranted. Third, cross-country research exploring whether differences in legal and institutional environments across countries can explain the prevalence of types of RPTs used for opportunistic purposes would be welcome and revealing. Fourth, more research is needed to investigate the moderating role of audit quality, audit fees and audit report lags on the association between different types of RPTs, firm value and accounting quality. Finally, researchers could also benefit from considering the information presented in Section 6 concerning the measurement of RPTs and failures to distinguish between opportunistic and conventional RPTs.

6. Research design issues

This section highlights two main research design issues that are very important in the context of RPTs. It discusses issues related to how RPTs are measured across different studies and outlines the weaknesses of different measurement approaches. Issues related to sample sizes in different empirical studies, the lack of relevant data for some countries and the implications of these issues are also covered.

6.1 Measuring related-party transactions

Several studies have measured RPTs in terms of the total dollar value of these transactions. For example, Gordon and Henry (2005) used two measures of RPTs: total number, and dollar amounts, of disclosed transactions. Chen *et al.* (2011) measured RPTs as the aggregate absolute dollar value of operating RPTs in year t between a listed subsidiary and its controlling shareholders scaled by total assets in year $t-1$. Gallery *et al.* (2008) measured RPTs using the dollar value of RP payments and loans deflated by average total assets. Nekhili and Cherif (2011) used the natural logarithm of the total number of RPTs. Cheung *et al.* (2009b) used the price of the RPTs included in their study sample. While researchers have generally been interested in capturing opportunistic RPTs, they have used total dollar amounts of RPTs, or dollar amounts of selected RPTs, which capture the monetary values of RPTs that are more associated with tunneling or other measures derived from the dollar value of all or specific types of RPTs (Gordon and Henry, 2005; Kohlbeck and Mayhew, 2010; Cheung *et al.*, 2006, 2009 a; 2009b; Gao and Kling, 2008). One familiar example of a measure derived from dollar value amounts of RPTs is that developed by Jian and Wong (2010). This measure isolates the effect of normal components of RPTs that might be associated with industry, size, leverage and growth in a fashion similar to decomposing accruals into normal and discretionary (abnormal) components (Lo and Wong, 2011). Hence, it could be argued that the resulting measure is more valid for capturing RPTs that are not related to the main factors that could affect the volume of RPTs. This approach was also used by Lo and Wong (2011) and Yeh *et al.* (2012).

More recently, Tareq *et al.* (2017) criticized measures that rely on dollar values of RPTs, or on proxies derived from these values. They argued that using dollar values of RPTs is subject to potential measurement error due to mixing legitimate RPTs conducted for business purposes with transactions conducted for opportunistic reasons. Tareq *et al.* (2017) also contributed to the RPTs literature by developing a new measure of RPTs – i.e. discriminatory RPTs (DRPTs) – which aims to capture only opportunistic or illegitimate RPTs that could have a negative effect on firm value and shareholders' wealth. To derive this measure, they extracted the components of RPTs that are driven by the determinants of opportunistic RPTs. They argued that the level of control by majority shareholders, the extent of their cash flow rights, and the interaction between control and cash flow rights should represent the segment of RPTs that relates to DRPT. However, this measure, because it only emerged recently, has yet to be used in other studies, so its validity and reliability remain to be explored. Nevertheless, it is the first measure to have decomposed RPTs into legitimate and illegitimate subsets using the determinants of DRPTs, rather than the determinants of RPTs in general (firm size, industry, debt, etc.).

Some studies have argued that the total amount of RPTs is an indication of the extent to which company insiders are open to self-dealing transactions, such as RPTs, and that this measure should thus not be ignored (Kohlbeck and Mayhew, 2017). Several studies have used indicator (dummy) variables to capture RPTs, avoiding the potential measurement errors associated with dollar values of these transactions. For example, Ryngaert and Thomas (2012) used a dummy variable equal to one if the total value of disclosed RPTs was more than 1 per cent of firms' total assets. Other studies have used transactions as a unit of analysis, instead of firms or firm years; for example, Lei and Song (2011) and Peng *et al.* (2011) used indicator variables to distinguish transactions conducted with RPs from other transactions. Ryngaert and Thomas (2012) argued that using dummy variables is preferable because assigning dollar values to RPTs involves non-trivial measurement errors. Assigning dollar values is deceptive, as it does not account for firm characteristics and thus might be misleading about the significance of RPTs undertaken by firms.

There are several challenges noted in prior studies related to measuring RPTs. First, most studies using RPT monetary amounts were conducted using Chinese samples where data on material RPTs must be disclosed (Jian and Wong, 2010). However, such monetary data may not be available in other countries. For example, in a US study, Balsam *et al.* (2017) show that not all firms that disclosed RPTs also disclosed the amounts of such transactions. This fact can serve to reduce the sample sizes available for researchers who are seeking to investigate the effects of RPTs measured in terms of their dollar magnitudes (El-Helaly, 2016; Balsam *et al.*, 2017). To overcome this challenge, most large sample US studies tend to employ dummy (indicator) variables to capture variations in the levels of RPTs (Kohlbeck and Mayhew, 2017; Ryngaert and Thomas, 2012; Balsam *et al.*, 2017). Second, as RPTs are extremely diverse, so it is also challenging for researchers to combine all RPTs for one firm in a single measure. Additionally, several transactions are also difficult to measure, and there is no one widely accepted proxy to capture them. Examples include loans and loan guarantees to RPs. Some studies have overcome the challenges related to measuring loans or loan guarantees to RPs by using an indicator variable for each type of RPT in a sample of connected transactions (Cheung *et al.*, 2006; 2009a, 2009b), while a few others have assigned dollar values for RP loans and loan guarantees. For example, Ryngaert and Thomas (2012) used the maximum amount reported on the loan to or from a firm in a given year to assign dollar values to a RP loan transaction. They also used the amount of loans being guaranteed to measure loan guarantees to RPs.

There are several research implications related to how RPTs have been measured in prior studies. First, as discussed, several studies have used dollar values of RPTs or measures derived from dollar values of RPTs. Given that potential measurement errors associated with this approach have been highlighted and the inherent challenges related to assigning dollar values to some types of RPTs, future research could benefit from replicating existing studies using different measures of RPTs, tighter identification strategies and different samples. This would improve our understanding of the reliability of the measures used to date. Second, there are several types of RPTs that vary in terms of frequency of occurrence, transaction value, materiality and impact on the firm's financial position; hence, future research could also benefit from addressing these types separately to determine how different measures could be designed for diverse types of RPTs. Third, research aiming to provide evidence on the types of RPTs that are more likely to be conducted in the presence of incentives to expropriate shareholders' wealth (DRPTs or abnormal RPTs), versus other types of RPTs that are more likely to be conducted for business purposes, could provide a significant contribution to the RPTs literature. Fourth, building on this, further research should examine the potential benefits of RPTs conducted solely for business purposes. Prior literature has only provided evidence that some types of RPTs are not associated with opportunistic behavior (Ryngaert and Thomas, 2012), yet little is known about the benefits, and thus the rationale, of those RPTs which are innocuous. Finally, a more evidence-based understanding of which measures of RPTs exhibit higher construct validity compared to others could help increase the robustness of RPTs research.

6.2 Data availability and sample size issues

An interesting discrepancy in the RPTs literature pertains to variations in data coverage across countries. For example, data on RPTs are more accessible in some Asian countries compared to other parts of the world due to specific RPT disclosure requirements. In China, listed companies have been required to disclose RPTs since 1997 (Jian and Wong, 2010), and RPTs exceeding a specific threshold must be reported to the stock exchange within two working days. Therefore, a record of RPTs can be obtained from the stock exchange. A similar requirement for disclosing RPTs exists in Hong Kong and relevant data are made publicly available by the stock exchange (e.g. Hong Kong Listed Companies: Corporate Documents*)*. However, similar regulations are not necessarily instituted in other countries, making data collection more challenging and time consuming.

This lack of available data, particularly for countries outside Asia, poses a significant challenge, and it is reasonable to expect that this may have negatively affected interest in this research domain. RPTs are disclosed in financial statement footnotes and researchers working on North American and European cases will have manually identified, extracted and systematically collated these data. For example, studies conducted using data from the USA, France and Greece have been based on small to moderate samples, between 84 and 331 firms (Ryngaert and Thomas, 2012; Gordon and Henry, 2005; Bennouri *et al.*, 2011; El-Helaly, 2016). On the other hand, studies such as those by Berkman *et al.* (2009), Jiang *et al.* (2010) and Peng *et al.* (2011), which used Chinese samples, have reported results based on samples of 875; 1,377; and 787 unique firms, respectively.

These significant variations in sample sizes across different countries have several research implications. First, the significance and generalizability of findings is intricately related to how much data provide the basis for inferential analyses. Thus, for example, it could be worth investigating whether the results reported by Ryngaert and Thomas (2012), that some RPTs are not associated with opportunistic behavior, are robust to a larger sample. Second, the disproportionate focus on Chinese samples in the literature obviously impedes our ability to make cross-country generalizations from the literature.

Researchers interested in RPTs could make a significant contribution to the literature by conducting meta-analytic reviews to investigate the relationship between RPTs, corporate governance, earnings management and firm value. RPT studies have been conducted using data for different countries and over different periods (García-Meca and Sánchez-Ballesta, 2009). Further, these studies are heterogenous in terms of empirical methodologies, not least with respect to identifying and testing for adherence to the assumptions underlying those methodologies. This makes the process of drawing substantive conclusions difficult. Therefore, meta-analytic reviews that aim to identify the determinants and consequences of RPTs would be useful. Meta-analytic reviews can account for sampling error and other statistical artefacts in the data (Hunter and Schmidt, 1990), and they also standardize the findings of different studies by considering effect sizes (the effect of sample size on the results reported by prior studies). Additionally, the relationship between RPTs and any variable of interest could change based on variations in the legal environment, rule of law, investor protection or any other institutional variables, and meta-analyses can control for those variables and test their moderating effects on the investigated relationship (García -Meca and Sánchez-Ballesta, 2009).

7. Suggestions for future research

There have already been numerous studies conducted to investigate the determinants and consequences of RPTs especially in Asian economies. But there are still many opportunities for future research arising from variations in institutional environments, different research methodologies that are underrepresented in the RPTs literature, ongoing developments in IFRS and local accounting regulations related to RPTs, and the fact that some important research questions related to RPTs have been tackled to an extent but not sufficiently investigated.

7.1 Variations in institutional environments

Given the close link between RPTs and investor protection, future research should focus on the effects of RPTs in different countries. As already noted, not all RPTs are conducted for fraudulent or opportunistic purposes. However, the literature on RPTs shows that on average, opportunistic RPTs are more common in countries with lower levels of investor protection, rule of law and accounting enforcements. Therefore, examination of the effects of RPTs in a cross-country setting that controls for variations in the abovementioned institutional factors is warranted and could provide significant contributions to the literature.

Poor legal protection of investors provides incentives to controlling shareholders to expropriate wealth from minority investors and conceal private control benefits from outsiders to avoid disciplinary actions that might be taken by outsiders if those benefits were detected (Leuz *et al.*, 2003). Thus, variations in investor protection which is highly correlated with other proxies for the strength of the legal and accounting environment like the rule of law (Kaufmann *et al.*, 2014) and enforcement of accounting and auditing standards (Brown *et al.*, 2014) is a crucial variable that should be considered when investigating the effects of RPTs. In countries with strong legal environments, there are more effective litigation channels and enforcement actions that could critically disincentivize conducting RPTs for opportunistic purposes.

Additionally, it might be argued that some types of RPTs, even if conducted for opportunistic purposes, are not sensitive to the strength of the legal environment or accounting standards enforcement. This argument calls for investigating the effects of different types of RPTs while controlling for variations in institutional settings.

7.2 Alternative research methods

The diversity of topics covered by RPTs research necessitates the application of a variety of research methodologies. However, thus far, researchers have relied mainly on quantitative methodologies (Elhelaly, 2014). It is worth noting that most of the findings from RPTs studies that rely on quantitative methodologies are drawn from observed associations. Therefore, research using alternative research methodologies that can provide evidence on causal relationships between RPTs and several consequences related to RPTs is highly encouraged.

To elaborate, field-based research could provide evidence to support the presence of causal links between variables. For example, to identify factors that could indicate the existence of RPTs and poor accounting quality, field-based research could investigate the process of authorization of RPTs, the views of managers and auditors on the relationship between RPTs and accounting quality, and/or firm performance/firm value (Jorgensen and Morely, 2017).

Also, experimental research could help address several research questions in the context of RPTs. For example, experimental research designs could be useful for investigating the effects of introducing a new regulation or a new auditing standard on variables such as the number of RPTs, the monetary value of transactions, the effect of such transactions on accounting quality, shareholders' wealth and internal governance mechanisms. Such changes in regulation or the accounting standards governing RPTs could provide evidence on changes in the behavior of firms, investors or regulators. Experimental research designs could also be useful in investigating whether countries that introduced substantive changes related to accounting enforcement experienced changes in the frequency and effects of disclosed RPTs after introducing those changes.

Finally, qualitative methods such as surveys and interviews could enhance our understanding of the perceptions of various stakeholders about RPTs. Interviews could be used to understand the views of users of financial statements concerning RPTs. Another issue that could be investigated using qualitative research methods is related to how financial analysts and regulators interpret RPT disclosures by different firms. Additionally, both experiments and surveys could be used to examine the behavior of auditors involved in RPTs and unravel how those auditors perceive and respond to different risks associated with RPTs, namely, litigation and reputational damage risks. Finally, surveys or interviews could clarify how investors of a firm that undertakes material RPTs understand the risks and benefits of RPTs, how they interpret their investees' RPTs disclosures, and whether they have sufficient understanding of the risks and benefits of RPTs in general.

7.3 Developments in accounting standards and accounting regulations

As discussed, RPTs have been linked to high-profile accounting scandals such as Enron, Tyco and Adelphia in the USA, Rundenweke and Parmalat in the EU and others around the world. Consequently, accounting regulators have discovered many shortcomings related to reporting and disclosing RPTs. Therefore, RPTs have become a major concern for accounting regulators in different countries. For example, the US PCAOB issued a new auditing standard (AS) 18 to provide guidance to auditors on the audit procedures required to provide reasonable assurance that RPTs are properly identified, accounted for, and disclosed. Also, several countries including Albania, Armenia, Egypt and Greece identified that RPTs conducted within their jurisdictions could be disadvantageous to minority shareholders and hence introduced specific regulations for reporting and disclosing RPTs.

Changes in regulations related to RPTs, including those discussed above, could provide an opportunity for conducting natural experiments to assess the efficacy of such changes in decreasing the potential negative effects of RPTs in different country contexts. For example, countries introducing new regulations related to reporting and disclosing RPTs vary in terms of legal enforcement; thus, these new regulations cannot be divorced from the wider context in which they are instituted.

An additional avenue for future research could be investigating how mandating IFRS in EU countries has affected the relationship between RPTs and shareholder expropriation. EU countries are heterogeneous in terms of legal systems (common law vs civil law), rule of law, investor protection, accounting enforcements and other institutional variables. Therefore, studies drawing conclusions from natural experiments or difference-in-differences analyses on the relationship between RPTs and various outcomes such as accounting quality, firm value, firm performance and shareholder expropriation could enhance our knowledge about the effects of RPTs before and after mandatory IFRS adoption in 2005.

7.4 Other important research questions

There are other avenues for future research within the domain of RPTs. First, there is a dearth of research focusing on the association between RPTs and different types of audit risks. Additionally, research that aims to disentangle litigation risks from other audit risks is warranted to better understand what are the other audit risks that are associated with the frequency or volume of RPTs and how the presence of RPTs affects auditors' perceptions of litigation and reputational damage risks.

Future research could also seek to investigate whether the consequences of RPTs in family firms are different from those in non-family firms. Although family firms face more severe Type II agency problems, there is a dearth of research investigating whether the RPTs conducted by family firms are done so for opportunistic purposes and in line with the objective of facilitating family members' entrenchment in management positions. Or, perhaps, RPTs conducted by family firms are less likely to be opportunistic as the family wishes to avoid damages to its reputation, wealth and long-term performance of the company (Bennouri *et al.*, 2011).

It is also important to further explore how RPTs trigger regulatory attention arising from concerns about the quality and transparency of firms that conduct and disclose RPTs compared to firms which tend not to conduct or disclose these transactions. To assess this, one suggestion would be to investigate the relationship between RPTs and receiving SEC comment letters in the USA. Other similar proxies for regulatory attention could also be identified and applied in other countries.

Finally, it is important to investigate the relationship between internal auditing as a monitoring mechanism and RPTs. Bailey (2016) argues that internal auditors can identify red flags related to RPTs and reduce the risk and impact of RPTs. However, this remains to be empirically investigated. Additionally, various research methods could be applied to identify causal linkages between internal auditing and the consequences of RPTs as well as logical mechanisms that satisfactorily explain how internal auditing can achieve its objectives. Exploring and identifying causality is inherently complex in all areas of applied research and calls for a multi-pronged, mixed methodological approach whereby quantitative evidence on observed associations is coupled with insights from experimental and qualitative methods.

8. Conclusion

In this paper, empirical evidence investigating various aspects related to RPTs has been reviewed. Understanding the nature, extent and consequences of these transactions is important not least because these transactions have featured in several high-profile accounting scandals in different countries.

This review started by defining RPTs and explaining two competing theories about the motivation and rationale behind conducting RPTs. Next, arguments concerning how and why RPTs are related to audit risks were explored before a synthesis and discussion of the literature investigating the role of monitoring mechanisms in RPTs. Then, arguments and empirical evidence for suggesting that not all RPTs are fraudulent or conducted for opportunistic purposes were covered. The review then considered some important research design issues in this domain before suggesting several avenues for future research that could contribute to and enrich our understanding of RPTs as well as the interaction between RPTs and institutional variables that vary markedly across different countries.

The analysis of the extant empirical literature identifies three risks that have been associated with RPTs: expropriating minority shareholders' wealth through tunneling, reduced earnings quality for firms conducting RPTs, and declining firm performance and valuation. The review shows that firms conducting RPTs are more likely to engage in tunneling. In addition, the evidence reviewed in this literature survey suggests that RPTs are more likely to exhibit a negative, rather than a positive, relationship with the quality of reported earnings. Results of prior studies have shown that RPTs are more likely to be associated with earnings management, lower disclosure levels and lower value relevance. Finally, RPTs research has provided largely consistent findings that RPTs negatively affect firm performance and valuation. Such risks have several implications for auditors because they could negatively impact their reputations and expose them to litigation risks.

Future research could benefit from investigating whether RPTs conducted in countries with strong institutions are also associated with shareholder wealth expropriation. In addition, as institutional contexts affect financial reporting, auditing and auditing oversight, it would be worth investigating how the relationship between RPTs and accounting quality or firm performance varies across different countries that are heterogeneous with respect to legal and accounting-related enforcement, and thus investor protection. Another area of potential research relates to identifying and validating measures used to capture RPTs. This could help in avoiding measurement errors that might occur from some existing proxies that do not differentiate opportunistic RPTs (DRPTs) from other RPTs. This also provides an opportunity to better gauge and explore those types of RPTs that can be classified as efficient transactions and are value enhancing.

In addition, the paper reviewed literature investigating the effect of regulations, corporate governance and auditing on RPTs, and whether regulations, corporate governance and auditing can moderate the relationship between RPTs and negative outcomes that are usually linked to RPTs. Regulations, corporate governance and auditing are efficient tools for protecting minority shareholders from the negative effects associated with RPTs. The findings indicate that several regulatory responses to resolve issues related to RPTs have been successful in combatting tunneling. The results of prior studies have indicated that RPTs are generally associated with weak corporate governance mechanisms. In addition, corporate governance can significantly moderate the relationship between RPTs and firm performance or firm value. This shows that corporate governance might have a significant role in reducing the negative effects that are usually associated with RPTs.

Additional research is required to investigate the effect of regulatory changes on the occurrence and effects of RPTs, with a shifting emphasis away from Asian case studies to other parts of the world where the research base is currently more limited. Several countries have recently recognized the negative effect of RPTs on overall investor protection, and issued new regulations related to RPTs and their disclosures to better protect investors. However, no studies have yet investigated the effects of such regulatory changes on the relationship between RPTs and other variables of interest. Second, there is ample scope for examining the effect of mandatory IFRS adoption in EU countries in 2005 on the occurrence and disclosure of RPTs. Third, several questions remain regarding the relationship between RPTs and audit quality at the firm level, and between RPTs and the national audit environment and regulations at the country level.

While a few studies have examined the relationship between external auditing and RPTs, they tend to be based on US data. The findings of those studies have shown that RPTs are less common when the auditor is one of the Big 4 accounting firms, or when the audit opinion is unqualified. However, the evidence that is currently available suggests that the volume of RPTs is positively associated with higher audit fees. This indicates that auditors are more likely to perceive greater risk in assignments that involve a higher number of RPTs.

Finally, this review sheds light on several audit risks associated with RPTs. These risks include failure of the auditor to identify an RP, and impaired auditor independence – which has been associated with several fraud cases involving RPTs. Interestingly, several studies found no concrete evidence that auditors perceive RPTs as a significant fraud risk factor. However, more recent studies have found that RPTs are associated with higher audit fees which can be interpreted as evidence that auditors can now better recognize the risks associated with RPTs, and hence require higher fees from those firms who conduct such transactions.

There are two opposing theoretical views concerning RPTs in the literature. The first argues that RPTs can be used to optimize internal resource allocation and reduce transaction costs; the second, which pertains to agency theory, argues that RPTs can be used with the intent to expropriate by tunneling resources from listed firms (Chang and Hong, 2000). Therefore, one objective of this review was to compile evidence on RPTs to identify which view is better supported by the available empirical evidence.

Taken together, the results suggest that whether RPTs are conducted for business purposes as transactions that can achieve efficient resource allocation, or opportunistic transactions conducted to expropriate shareholders' wealth, is conditional on micro and macro control mechanisms. This is evident from the results of several studies that country-level regulations, corporate governance and external auditing can reduce the negative effects of RPTs, as discussed in Section 5. Thus, such control mechanisms can transform RPTs from opportunistic transactions, to efficient transactions with positive outcomes to the firm and its shareholders. In other words, under strict control mechanisms, efficient and beneficial RPTs are more likely to be approved/conducted. However, in the presence of a weak regulatory environment and corporate controls, managers and insiders might exercise their opportunistic incentives to conduct RPTs.

In summary, extant research on this topic is subject to the following general limitations. First, there is a lack of cross-country studies, hindering researchers from examining the effects of different institutional settings on RPTs and other variables of interest. Second, data on RPTs often need to be manually collected, which require extensive time and effort. This has undoubtedly served to diminish research attention to these transactions and has resulted in parts of the world being relatively understudied. Third, there is a dearth of research focused on drawing causal inferences which suggests that greater emphasis should be placed on natural experiments and methodologies like difference-in-differences analysis. Finally, the main feasible source of data on RPTs is the information disclosed by firms. This implies that whenever there is a transaction with an unknown RP or an RP that the firm does not wish to disclose, it is likely to remain unobservable and beyond the scope of auditors and regulators, as well as researchers. It is difficult to understate the importance of this because methodological improvements and innovations are always subordinate to the quantity and quality of available data.

Notes

1. Prior to 2005, only one third of the shares issued by listed firms in China were publicly tradable. The other two thirds, owned primarily by Chinese government agencies or government-linked companies, were prohibited from public trading. This structure led to serious corporate governance problems, and the Chinese Securities Regulation Commission launched the share structure program which abolished the split share structure, converting all non-tradable shares to publicly tradable shares (Zhu and Zhu, 2012).
2. In the European Union, where IFRS was mandated for listed firms in 2005, IAS 24, "Related Party Disclosures" was issued to mandate disclosures of RPTs and ensure that financial statements included all information about how these transactions might affect the financial position of firms.

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