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RELATED PARTY TRANSACTIONS AND FINANCIAL REPORTING QUALITY: A CONCEPTUAL PAPER

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ABSTRACT

Financial reporting quality is significant in sustaining a stakeholder's trust and confidence in making useful decisions, particularly for investors, as they accurately reflect a true picture of the financial health of a firm. A major concern is that related party transactions (RPTR) could potentially lead to recurring financial scandals and distort the quality of financial reporting. Related party transactions (RPTR) are legitimate and not prohibited. However, there is controversy over whether RPTR props up the wealth of shareholders or create conflicts of interest that expropriate shareholders via self-dealing. The ongoing debates in the literature on whether RPTR is beneficial or detrimental have motivated us to examine the relationship between RPTR and FRQ, as assessed by accrual quality. By postulating agency theory, this study predicts that the Malaysian public listed firm might use RPTR in association with downward accrual quality as well as an autonomous form of earning manipulations through conflicts of interest by opportunistic behaviours. This paper fills the literature gap by focusing on an area of sparse investigation in the Malaysian environment and seeks to extend the current stream of research by suggesting that future studies should test the RPTR-FRQ relationship.

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INTRODUCTION

Financial Reporting Quality (FRQ) is central in maintaining the integrity, transparency, and accountability of corporate reporting. FRQ presents accurate and reliable financial health of the companies that reflects its operating performance, forecasts future cash flow, and facilitates informed decision-making by investors and other stakeholders (Al-Shaer, 2020; Fan et al., 2022; Pham et al., 2022). FRQ is also closely linked to enhancing firm value and market efficiency (Ge et al., 2021)and increasing investor confidence, credibility, reputation and image of public listed companies (Zopounidis et al., 2020).

However, in recent years, multiple substantial corporate financial scandals have drawn the attention of stakeholders, who are now scrutinizing the financial reporting quality regarding the accuracy and fairness of financial position and performance (Ahmed Hashed & Ghaleb, 2023; Devarajar et al., 2022), leading to stakeholder mistrust and eroding investor confidence (Velte, 2023). A recurring theme in these scandals is the abuse or misuse of related party transactions (hereafter RPTR). Significant financial scandals associated with prominent companies, including the "Adelphia, Bank of Credit and Commerce, Cirio, Enron, Parmalat, the Subprime Mortgage Crisis and Worldcom", have employed earnings management techniques and opportunistic RPTR (Gavana et al., 2022) resulting in distorted financial reporting quality. Consequently, it can be inferred that RPTR is a significant factor contributing to the corporate scandal that transpires within the corporate sector.

RPTR represents dealings between affiliates, the parent company and its subsidiaries, or related individuals, as defined by accounting standards (El-Helaly, 2018). RPTR can be entirely legitimate, grounded in the supporting or efficient transactions hypothesis (Chen, 2023; Friedman et al., 2003; Habib et al., 2021; Peng et al., 2011). Eulaiwi et al. (2023) posited that RPTR exemplifies effective contracting between entities possessing superior information regarding a firm and a heightened motivation to disseminate that information. In addition, RPTR facilitates resource allocation and operational efficiencies within corporate groups (Bansal & Singh, 2023). RPTR supports the economic needs of a company and assists in the further expansion and development of the businesses (Rasheed et al., 2021; Tarighi et al., 2022; Zimon et al., 2021). Likewise, RPTR is sometimes performed to gain access to the experience, knowledge, and special skills of the related party or to pay for services. The benefit of RPTR can be achieved if there is no motivation to engage in profit manipulation in this insider dealing (Bona Sánchez et al., 2023; Yoon & Jin, 2021).

In contrast, opponents of the efficiency-enhancing theory contend that RPTS is perceived as tunnelling and is conventionally regarded as a mechanism for dominating owners to exploit minority shareholders (Wang et al., 2019). RPTR can compromise FRQ due to potential conflicts of interest, opportunistic behaviour and manipulation of financial statements by the management (Alhadab et al., 2020; Khuong et al., 2024; Tarighi et al., 2022; Yoon & Jin, 2021; Zimon et al., 2021). RPTs are often conducted opportunistically, resulting in lower earnings quality (Rahmat et al., 2020). Hope et al. (2024) disclosed the majority of instances of financial reporting fraud and signify potential risks of serious misstatements in financial statements pertaining to RPT.

In Malaysia, the prevalence of RPTR is particularly concerning due to the dominance of family-owned and concentrated ownership structures, where such transactions may obscure a firm’s true financial health, which undermines the quality of financial reporting (Rahmat et al., 2020; Zin et al., 2023). By way of example, IOI Properties Group Bhd is involved in a related party transaction (RPTR), which is the sale of a privately held corporation to the company by its CEO and major shareholder, leading to questions of conflict of interests and fairness to minority shareholders (The Edge Malaysia, 2024). In Malaysia, the Malaysian Financial Reporting Standards (MFRS) 124 governs RPTR (Ghazali et al., 2020), where section 228 of the Companies Act 2016 defines RPTR (Nor & Ismail, 2017), and Chapter 10, Bursa Malaysia Listing Requirements requires disclosures of related party transactions (RPTR) (Abdul Razak, 2020).

Despite regulatory initiatives to enhance transparency, RPTR continues to create governance challenges that erode financial reporting. RPTR controversy is affected by the shareholding conflicts arising from the opportunism of the dominant shareholdings on minority interests and opportunistic management taking advantage of their power to misappropriate resources from businesses for their personal advantage (Fooladi & Farhadi, 2019; Hasan et al., 2022; Marchini et al., 2019). According to Jensen and Meckling (1976) in agency theory, conflicts arise from aggressive RPTR, which underscores the agency dilemma and dominates shareholders or management use RPT for personal advantage, frequently at the expense of minority shareholders (Arayssi et al., 2020). The agency conflict adversely affects financial quality due to overestimation or understatement of earnings, which is detrimental since decisions based on such data may lead to resource misallocation and hinder financial progress (Wu & Abeysekera, 2023).

This study is motivated by the recent corporate scandal controversy in the RPTR misrepresentation of companies' financial reporting that affected the quality of financial reporting. Furthermore, there are two conflicting theories: whether RPTR is an efficiency enhancing theory as RPTR props up to improve the firm performance and benefits to shareholders or whether a conflict-of-interest theory in which RPTR may negatively affect firm performance and shareholders' wealth (Farooq et al., 2022; Habib et al., 2021; Sridhar & Jasrotia, 2020). Koepsell (2017) asserted that not all conflicts of interest are avoidable, nor are they inherently detrimental. As a result, it is imperative to identify when and how to avert conflicts, or at the least to maintain transparency on them as they emerge and to mitigate potential harm whenever feasible. RPTR is authentic and not prohibited. RPTR and the firms must execute RPTR to augment the efficacy of the internal capital market, optimize resource allocation, enhance information dissemination, and promote collaboration.

Hence, this study aims to identify and address this gap by utilizing Agency Theory to analyse the impact of RPTR on financial reporting quality in light of the prevalence of corporate scandals involving such transactions and adding to the theoretical debate from the perspective of the accounting consequences of RPTR among Malaysian non-financial listed public listed companies. The findings here will contribute to the literature. Initially, it contributes to the body of research on RPTR and FRQ, which are measured by accrual quality according to Agency Theory. A few have investigated the association of RPTR and FRQ (Alhadab et al., 2020; Alhadab & El Diri, 2024; Gavana et al., 2022, 2024; Khuong et al., 2024; Rahmat, Muniandy et al., 2020). However, the result is still inconclusive, implying that more research needs to be conducted (Gavana et al., 2024; Khuong et al., 2024). Furthermore, prior studies have investigated the influence of RPTR on the quality of financial reporting, yet the findings exhibit inconsistencies across different institutional contexts. Even so, research conducted in China generally presents a negative view of the impact of RPTs (Chen et al., 2020; Habib et al., 2021; Song, 2023).

Second, although extensive studies have been conducted on RPTR across different contexts in Malaysia, a significant gap remains in understanding their influence on financial reporting quality (FRQ), particularly in terms of accrual quality, within the Malaysian market. Prior research has examined various aspects of RPTR: Fooladi and Farhadi (2019) examined the influence of RPTR and governance on corporate value; Abd Majid et al. (2023) analysed related party transactions (RPTR) concerning independent directors; Abd Majid et al. (2020) studied the relationship between RPTs and sukuk financing; Zin et al. (2023) assessed the impact of family businesses on financial misreporting associated with RPTR; and Rahmat et al. (2020) examined the effects of complex, simple, and loan-based RPTR on earnings quality. In the same year, Rahmat et al. (2020) conducted RPTR on the informativeness of accounting earnings. Nonetheless, there is a scarcity of research that has specifically examined the effects of RPTR on FRQ through the lens of accrual quality.

This work contributes to the current literature by theoretically examining the relationship between RPTR and FRQ via the lenses of efficiency-enhancing theory, conflict of interest perspective, and agency theory, specifically in the context of emerging countries. The study's findings are significant for policymakers, investors, and governance entities aiming to improve transparency and safeguard minority shareholders by advocating for superior financial reporting standards and instituting stringent corporate governance practices to oversee and ensure RPTR operates in the interests of stakeholders.

The subsequent sections of the paper are organized as follows. Section 2 examines the theoretical framework and the formulation of hypotheses. Section 3 outlines the methodology and data utilized in this study.

LITERATURE REVIEW

Theoretical background

Agency theory has been extensively used in literature to explain the relationship between RPTR and FRQ, such as earning management (Tarighi et al., 2022) and financial reporting manipulation (Šodan et al., 2023). Eisenhardt (1989) posited that agency theory provides valuable insights into information systems, the uncertainty of outcome, incentives, and risk and asserts its empirical validity, especially when integrated with complementary perspectives. The primary recommendation is to integrate an agency perspective in examining various issues characterised by a cooperative framework. Similarly, Thanh Liem (2021) claimed that agency theory provides empirical insights into the motivations behind the misrepresentation of firm performance via accruals-based earnings management, which stems from the opportunistic behaviours of insiders. Thus, agency theory remains relevant in financial reporting as it supports the identification of issues such as earnings management, which may result in fraud and accounting information asymmetry in the business (Flayyih & Khiari, 2023).

Jensen and Meckling (1976) posited that the separation of ownership and control in modern corporations creates opportunities for managers (agents) to act in their own interests rather than those of shareholders (principals). RPTR often demonstrates this conflict as it can be used by controlling shareholders or management to divert resources for personal gain, thereby reducing the transparency and quality of financial reporting (Din et al., 2022). Consequently, managers may engage in profit management to obscure this wealth transfer (Gordon & Henry, 2005).

In the context of Malaysian firms, where concentrated ownership is common, agency problems between majority and minority owners tend to exacerbate the negative effects of RPTs on FRQ (Abd Majid et al., 2023; Kolsi & Al-Hiyari, 2024). Through the lens of agency theory, Flayyih abd Khiari (2023) found a positive significant relationship between earning management of Malaysian public listed companies and directors' remuneration and firm size. This finding is consistent with agency theory predictions whereby opportunistic real reporting negatively affects future economic performance. Mahyuddin et al. (2020) empirically examined whether managing earnings that meet targets affect firms' future performance by using a sample of firms from year 2001 to 2015. The results indicated that the opportunity to manipulate the real-based earnings management is linked to future performance, which confirms the agency theory and shows that the firms characterized by opportunistic reporting are likely to suffer from poor subsequent economic performance. Thus, previous studies have shown that agency theory is relevant to explain the relationship between firms (owner and agents) and financial reporting quality.

This section contains a framework that explains the relationship between variables in theory and analysis supported by previous research. This section does not contain a sub-literature review or literature review.

Overview Related Party Transactions in Malaysia

A Related Party Transaction (RPTR) is defined as a transaction that involves the interest of a related party, either directly or indirectly, as specified by the Malaysian Accounting Standards Board (MASB, 2010). Section 7 of the Companies Act 2016 defines related corporations as those where one is the holding company of the other, one is a subsidiary of the other, or both are subsidiaries of the same holding company. Section 197 of the Companies Act 2016 delineates the criteria for an individual's connection to a company. This encompasses family members of a director, corporations linked to the director, and trustees of trusts, excluding those established for employee share schemes or pension schemes - where the director or their family members are beneficiaries. Section 225 further prohibits a company from extending loans or offering security for loans to individuals associated with the director of its holding company (Companies Commission of Malaysia, n.d.).

Moreover, the disclosure requirements for related party transactions (RPTs) are specified in MFRS 124 and the Bursa Malaysia Listing Requirements, which apply to all publicly listed companies. Companies are required to disclose related party transactions by documenting the interests of the parties involved. MFRS 124, Paragraph 18 requires reporting entities to disclose information distinctly for each category, which includes the parent company, entities with joint control or significant influence, subsidiaries, associates, joint ventures where the entity acts as the operator, key management personnel of the entity or its parent, and other related parties (Waad et al., 2021). This mandatory disclosure requires the identification of the relevant party, a description of the relationship with the related party, the nature and number of transactions involved, and the outstanding balance (Md Nor, 2019). Bursa Malaysia Listing Requirements stipulate that all listed companies are required to disclose Related Party Transactions Report (RPTR) in compliance with MFRS 124, provided they meet three essential criteria: disclosure, transaction magnitude, and shareholders' approval (Bursa Malaysia, 2021). Consequently, related party transactions that satisfy the established materiality threshold are required to be disclosed and must obtain approval from shareholders.

The 2000 Malaysian Code on Corporate Governance (MCCG), amended through 2021, has raised governance standards above legislative requirements. Malaysia's 2017 and 2021 upgrades strengthen governance integration, board policy, and sustainability monitoring, indicating its commitment to strong, globally linked governance frameworks and sustainable responsibility (Securities Commission Malaysia, 2021). Malaysian companies participate in related party transactions (RPTs) in the context of corporate governance challenges, underscoring the impact of regulations such as the Malaysian Code on Corporate Governance (MCCG) on shareholder confidence and financial reporting disclosures concerning RPTs (Kamwani & Yahya, 2021).

The MCCG serves as a significant tool for corporate governance reform and strengthens the adoption of best practices among Malaysian public companies. Rahmat et al. (2021)

revealed that even though the MCCG document is advanced, there is still a lack of enforcement mechanism, which raises concerns regarding effectiveness, potentially promoting participation in related party transactions. Additionally, Kuek et al. (2021) contended that the Minority Shareholder Watchdog Group (MSWG) has an ineffective role in protecting minority shareholders from oppressive related party transactions (RPTR). Indeed, Kamwani and Yahya (2021), and Rahmat et al. (2021) highlighted that Malaysian culture and norms do not oppose authority, which further promotes the adverse effects of RPT. Hence, these problems highlighted the importance of the need for Malaysia to have stricter implementation and particularly treat enforcement of RPTs as a signal to the country about the need to enhance FRQ. Research on RPTR and FRQ in this context is essential to provide insights that may guide policy improvements, enhance transparency, and promote investor confidence.

To summarize, Malaysia's plan for regulating RPT reflects a robust regulatory framework towards better corporate governance and the protection of investors. However, while the framework is elaborated, its results ultimately rely on eager enforcement and the vigilance of stakeholders (for example, auditors and regulatory bodies) to enforce compliance. While the rules that have been established are a step in the right direction, ongoing monitoring and potential adjustments to the materiality thresholds may be necessary to address new issues that may arise with respect to corporate governance and financial reporting quality.

Accrual Quality

Quality of Accruals is the accuracy of a company's accruals in financial reporting. Drawing on the model by accrual quality reflects the extent to which a firm accrual is aligned with its realized cash flows across different horizons: past, current, and future. According to this model, 'accrual' refers to adjustments for recognizing revenues and expenses when they occur rather than when there is a cash transaction, thereby allowing the cash flow to be aligned with the actual economic return of a firm (Dechow & Dichev, 2002; Vafeas & Vlittis, 2023). Accruals adjust cash flows across periods for high financial reporting quality representation. Francis et al. (2005) posited that investors evaluate securities based on their understanding of accrual quality, noting that lower-quality accruals correlate with increased debt costs, reduced price multiples on earnings, and elevated equity betas.

An abundance of studies is being conducted on accrual quality. For example, Li et al. (2024) examined the correlation between critical audit matters (CAM) and the quality of accruals. They found that a higher number of critical audit matters (CAM) correlates with poorer accruals quality, particularly in recurring CAM-associated tax and revenue. In a different context, they showed that discretionary accruals quality presents a relevant tool for investors to obtain inclusive future returns. The quality of discretionary accruals is one part of enhancing the model in predicting future performance based on the effect of dividends (Siladjaja, 2020). In terms of the RPTR perspective, some studies illustrated that RPTR has a negative impression through which they increase earnings manipulation probabilities and reduce accrual quality (Alhadab et al., 2020; Khuong et al., 2024; Rahmat et al., 2020; Tarighi et al., 2022; Zimon et al., 2021). Accrual quality, an indicator of the precision and dependability of accrual-based accounting, is frequently employed to evaluate the quality of financial reporting. Accrual quality and the timing of financial reporting have implications for the probability of default by an organization and, therefore, are important predictors of financial distress.

Related Party Transactions, Enhancing Efficiency, Conflicting Interest and Financial Reporting Quality

Eulaiwi et al. (2023) conducted a study in Gulf Cooperation Council (GCC) countries, analysing a sample of 1,810 firms from 2005 to 2016. The results revealed that greater total RPTR and purchase-based RPTR raise firms' cost of debt. In addition, neither the sales-based RPTR through supportive sales has a significantly strong influence on the debt costs of the firms. Thus, this sentence has a more human-friendly style: For such countries, the authors consider the purchase-based RPTR to be positively associated with firm financing costs in a stronger way when the related party transaction disclosures are more strongly associated. From the perspective of firm performance, Bansal and Singh (2023) examined the effect of market competition on RPTR using a sample of 12,794 firm-year observations from public listed Indian companies and found that in a competitive market, RPTR is positively correlated with firm value. Similarly, Rasheed et al. (2019) suggested that the efficiency of transactions can be gained by lowering transaction costs and enabling a smooth flow of goods and services to satisfy the economic needs of the parties concerned. When RPTs are consistent with efficiency-enhancing theory and the Indian regulatory framework is effective in curtailing abusive RPTR, RPTs may enhance firm performance in India.

Nevertheless, several studies have found contradicting findings of the study. Engaging high RPTR may potentially cause value destruction and decrease financial reporting quality (Alhadab et al., 2020; Khuong et al., 2024; Tarighi et al., 2022; Yoon & Jin, 2021; Zimon et al., 2021). For example, Alhadab et al. (2020) investigated RPTR and earning management (accrual and real) by using samples from publicly listed companies in Jordanian for the period 2011-2017 and found that accrual earning management has a converse relationship with RPTR but no significant association between real management and RPTR.

Similarly, Tarighi et al. (2022) conducted a study in Iran and revealed that companies with financial distress have poor financial reporting quality and are consistent with tunnelling transactions through RPTR to expropriate firm resources and manipulate financial reporting. Rahmat et al. (2020) examined the impact of RPTR on earnings quality across four East Asian nations: Malaysia, Hong Kong, Singapore, and Thailand. It was demonstrated that firms exhibiting high RPTR and weak capital markets are associated with low earnings quality. The impact of RPT-simple on earnings quality is greater than that of RPT-complex. Khuong et al. (2024) examined 413 non-financial firms in Vietnam from 2015 to 2019 and found a positive relationship between RPTR and earnings management, which results in low financial reporting quality and facilitates greater engagement in earnings manipulation by the firms.

In conclusion, the evidence regarding the relationship between RPTR and financial reporting quality, particularly concerning earnings management and earnings quality, is inconclusive. There are also divergent perspectives stemming from the efficient transaction hypothesis and the conflict-of-interest hypothesis. Consequently, we formulate hypotheses regarding the correlation between RPTR and the quality of financial reporting as assessed through accrual quality.

H 1 : Related party transactions (RPTR) are negatively associated with accrual quality.

RESEARCH METHODS

The sample consists of firms listed in Malaysia, covering the period from 2019 to 2023. The selection of this sample is intended to facilitate a natural experiment framework for analysing related party transaction reporting (RPTR) and accrual quality. This study, focusing on the relationship between related party transactions (RPTs) and financial reporting quality (FRQ), will leverage data from Malaysian firms within the specified period. The 2021 Malaysian Code on Corporate Governance (MCCG) revisions tightened governance and reporting regulations. These adjustments improved transparency and investor trust; therefore, RPTR and FRQ must be examined. In addition, firms also faced fiscal hurdles from the COVID-19 pandemic, testing RPTR and FRQ requirements. Studying post covid or aftermath-COVID helps promote corporate transparency and accountability by revealing Malaysian governance practices.

CONCLUSION

This study will investigate the potential influence of related party transaction reporting (RPTR) on financial reporting quality (FRQ) in Malaysian public listed companies, with FRQ measured through accrual quality. By drawing on agency theory, the study considers how the separation of ownership and control in corporations can create opportunities for managers (agents) to prioritize personal interests over those of shareholders or lead to conflicts between controlling shareholders and minority shareholders. Although RPTR is a legal and commonly occurring business transaction that can sometimes enhance operational efficiency, it also carries inherent agency risks and higher agency costs, particularly in the absence of robust corporate governance.

This opportunistic behaviour by management or controlling shareholders can create opportunities for earnings manipulation, reduce transparency in reporting, and ultimately degrade financial reporting quality. Given the unique governance environment in Malaysia, this study underscores the need for enhanced regulatory oversight and strong internal controls to mitigate the risks of exploiting related party transactions and to protect the interests of minority shareholders. This paper provides future empirical frameworks of studies that test the RPTR-FRQ relationship while possibly analysing the mediating factors, such as the independence of the board of directors and the effectiveness of audit committees.

In addition, it is recommended that ESG performance is incorporated as a moderating variable, which might provide more information regarding the impact of RPTR on FRQ. In this regard, the following findings indicate informative insights to the Malaysian regulators, auditors, and policymakers in improving the disclosure regulation and governance framework to ensure that the RPTR is in the best interest of shareholders to protect the credibility of financial reporting.

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