

The Breadth and Depth of Related Party Transactions Disclosures

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Abstract—This paper reviews the existing requirement on related party transactions (RPTs) disclosure in the Malaysian context and discusses issues surrounding such disclosure. As there are two conflicting effects of RPTs, sufficient information should be made available to assist investors in analyzing the risk and return of RPTs. We review prior studies and highlight issues of information disclosure related to RPTs, such as the variations in the level of RPTs disclosure. We propose future research on RPTs to apply content analysis using a voluntary disclosure index to understand more about the breadth and depth of the RPTs information.

Index Terms—Related party transactions, disclosure, Malaysia.

I. INTRODUCTION

This paper reviews existing requirement on related party transactions (RPTs) in Malaysia and highlights issues surrounding such disclosure. RPTs, which refer to transactions with parties that are related, are common features in Malaysian economy. The prevalence of RPTs is not a surprise because cultural and political forces lead to a relationship-based system in the economy. From the perspective of investors, RPTs are a fact of life in investing in Asia, generally, and Malaysia specifically.

However, the 1997 Asian financial crisis has created a generally accepted view that RPTs in the Asian region are abusive in nature. This view is substantiated by at least three reasons. First, in the case where the controlling shareholder own private interests outside of the listed company such as in Asia, a significant risk of abusive RPTs exists [1]. Second, the relationship-based corporate governance and business systems in Asia provides a perfect environment that allows controlling shareholders to profit at the expense of the company's financial health—whether because company assets are sold at an excessively low price, assets are purchased at an inflated price or loans are given by the company to controlling shareholders on terms far better than the market offers [2]. Unlike Anglo-American jurisdictions, RPTs in Asian groups are typically either transactions of revenue or trading nature, or asset transfers [3]. Third, the inappropriate institutional, law and legal enforcement in the East Asian countries [4] that shields controlling shareholders from internal governance structure, facilitates the practice of abusive RPTs. The negative perceptions involving RPTs in East Asia are supported by the many fraud incidences

involving related parties [5] and empirical evidence from existing literature in those countries. Nevertheless, many reforms have been undertaken by countries in East Asia to deal with abusive RPTs. These include the accounting standard on RPTs (IAS 24), strengthening the capital market regulations and approval procedures on RPTs, and providing guidelines for best practices on RPTs. The revamped Bursa Malaysia Listing requirement following the Asian Financial crisis, for example, has attributed a great deal in the issues surrounding substantial and related party transactions. While Asian jurisdictions are commonly noted for abusive RPTs, shareholders in many of the Asian countries enjoy substantially better protection from abusive RPTs than shareholder in many 'developed' jurisdictions [3].

Empirical research has analyzed the economic consequences of RPTs information. Prior research focuses on RPTs disclosed in the annual reports, filings, and circulars. Our review on RPTs requirement and empirical evidence suggests that non-monetary information should be considered in measuring RPTs. We also find that there are different managerial incentives behind the different types of RPTs disclosure. Reviews provided in this conceptual paper benefits future research in the area of financial reporting quality, generally, and RPTs specifically. We propose that a disclosure index needs to be developed to capture the breadth and depth of information on RPTs in publicly available information to assist in understanding the true value of RPTs disclosure by firms.

This paper proceeds as follows, Section II discusses the requirement for RPTs information in Malaysia, followed by reviews on empirical research on RPTs in Section III. In Section IV, we highlight issues on RPTs disclosure, while Section V concludes.

II. REQUIREMENT FOR RELATED PARTY TRANSACTIONS DISCLOSURE IN MALAYSIA

RPTs are defined as deals entered into by at least two entities, one of which has control over the other or where the parties come under the same control of another [5]. Normal business transactions fall into the category of RPTs when the transfer of resources, services, or obligations occurred between related parties. Among parties that can be considered as 'related' are directors, officers, and controlling owners.

Annually published financial statements are one of the sources of RPTs information, and as such, discussion on accounting standards for RPTs is of relevance. Prior to full convergence with the International Accounting Standards Board (IASB) in 2012, RPTs in Malaysia are accounted using FRS124. The standard has gone through a revision in 2010, which sees some amendments involving definition of related

Manuscript received May 18, 2013; revised July 27, 2013. The study is supported by Research Acculturation Grant Scheme (RAGS: Vote No. 57089) from the Ministry of Higher Education of Malaysia.

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parties and disclosure for government-related entities. The definition of related parties was simplified, its intended meaning was clarified, and inconsistencies were eliminated from the definition. For government related entities, the amendment involves changes from 'no disclosure' to 'partial exemption from disclosure' for transactions between government-related entities. Effective 2012, firms are required to apply MFRS124 which is a standard equivalent to accounting standards for RPTs prescribed by the IASB i.e. IAS24. The standard has also gone through several revisions, undertaken to respond to concerns that the previous disclosure requirements were too complex and difficult to apply in practice, especially in environments where government control is pervasive [6]. The revised IAS 24 has received positive review, especially in terms of the benefits that it can bring to the financial reporting and disclosure on RPTs. Among things that must be disclosed according to the accounting standards include relationships between parents and subsidiaries, management compensation, and related party transactions such as the amount of the transactions, the amount of outstanding balances, including terms and conditions and guarantees [7]. Requirement for RPTs disclosure are also detailed in Chapter 20 of the Policies and Guidelines on Issue/offer of Securities by the Securities Commission of Malaysia [8]. Beside definition on RPTs and related parties, the guidelines contain the requirement for firms to: a) make an announcement containing brief details of RPTs, b) send circulars to shareholders to provide information such as the nature and types of transactions and related parties and their relationship, which are to be attached with letters of recommendation from independent directors, board of directors, and independent advisers, c) obtain approval of its shareholders, and d) ensure that the related party abstains from voting on the relevant resolutions.

Chapter 10 of the Bursa Malaysia Listing Requirements sets out the requirements that must be complied by firms in respect of transactions that they entered into, including those that relate to related parties. The provision in the requirement follows a tiered approach, where some transactions require retrospective reporting, some require stock exchange disclosure, and others require public disclosure and shareholder approval. Percentage of relevant ratios is used to determine the applicable requirement. For example, firms need to make an announcement for RPTs that exceeds 0.25 percent of any of the percentage ratios, except in the case of recurring RPTs. There is also a provision for aggregation of transactions for which small transactions are treated as one, and shareholder approval is required for such transactions. Besides, there is a provision that abstain related parties from voting on the relevant resolution in respect of the related party transaction.

More recently, Bursa Malaysia have amended the Listing Requirement by adding a provision for poll voting for RPTs that require shareholder approval. Mandating poll voting for RPTs, which allows voting to be done on the principle of one share one vote, gives a fairer voting ability in Malaysian context where bulky shareholders structure is still prevalent [9]. The inclusion of this provision is in line with the best practice recommended in the Malaysian Corporate Governance Blueprint, which takes effect in 2012. The board is encouraged to put substantive resolutions to vote by poll

and make an announcement of the detailed poll results.

With the many reforms on RPTs in Malaysia, such as the provision that allows for aggregation of transaction and shareholder approval using tiered approach, the scope of protections available to shareholders to curb abusive RPTs can be significantly increased. Comparing shareholder approval for RPTs between major jurisdictions, [3] indicate that investors protection from risks of abusive RPTs are greater in certain Asian jurisdictions than in other markets where RPTs receive less attention. Thus, reforms undertaken to deal with the issues surrounding substantial and related party transactions could potentially lead to better investor protection and greater financial reporting quality in Malaysia.

III. THE IMPORTANCE OF RPTs DISCLOSURES

Appropriate disclosure of RPTs is considered vital for financial statement users to make decision and understand the impacts of the transaction on the company [10]. There are two conflicting impacts of RPTs. Under the efficient transaction hypothesis [11], RPTs are sound business exchanges that fulfill the economic needs of the firm. RPTs may be in the best interests of shareholders as they can reduce transaction costs, optimize internal resource allocation, and improve return on assets. In this propping view, RPTs are considered as value-enhancing mechanisms designed to improve efficiency. In contrast, under the principal-agency conflicts theory by Berle and Means in 1932, RPTs are economically harmful for the firm. RPTs that are tainted with conflict of interests can lead to the potential expropriation of the firm's resources and are detrimental to the shareholders' wealth [11]. In this tunneling view, RPTs refer to a form of private benefits of control, which is used as a mean to transfer funds from a firm's resources to the hands of controlling shareholder (or managements) at the expense of other stakeholders. We review RPTs information used in existing studies on RPTs.

A line of study focuses on disclosure of RPTs in the annual report, by looking at the footnote information regarding RPTs. Among the items typically used to represent RPTs are sales, purchases, and loans with related parties. Reference [12] finds support for the propping up hypothesis as the level of related sales is positively correlated with the condition that firms plan to issue seasoned equity next period and the condition of a decrease in the reported earnings. They also find support for the internal capital market hypothesis as the level of related lending and guarantee is negatively correlated with the condition of an increase in capital expenditure and an increase in net working capital. Additionally, their empirical results indicate that corporate governance moderates the relation between the motives and the level of RPTs. Focusing on firms in Malaysia, [13] rely on the monetary value of related asset acquisition, asset sales, equity sales, trading relationship and cash payment. They show that RPTs carried out by family-owned firms are more likely to be used opportunistically to expropriate minority investors. Reference [14] finds that receivables and payables from RPTs exhibit a significant positive relationship with performance, and sales and purchases of goods from RPTs exhibit a significant negative relationship with performance. They conclude that RPTs affect enterprise value, but cannot

be used to estimate the optimal results because there are many types of RPTs that typically are conducted through complicated process. Hence, it becomes quite difficult for outsiders to accurately identify the effect of RPTs on corporate value. Reference [15] relies on payables and receivables turnover ratio and the proportion of debt guarantees to total assets to represent RPTs. They find that firm performance is positively associated with RPTs, but negatively associated with RPTs which result in expropriation of firm's minority shareholders. In addition, control mechanisms minimize the negative impact of RPTs. Their study provides the evidence that RPTs which result in expropriation of firm's minority shareholders exist in the form of irregular credit terms and excessive loan guarantees.

There is a provision of laws in each country that requires firm to issue an immediate report of transactions with related party to shareholders. The circulars to shareholders must provide full details of the transaction, which is to be followed by approval of the transaction by shareholders in a general meeting. A line of studies refer to these circulars. Reference [16] analyzes the cumulative abnormal returns surrounding the announcement made by Israeli firms. The RPTs in the announcement are classified into three categories; fiscal transaction, financial transaction, and compensation transaction. Fiscal transaction refers mainly to buying (selling) a real asset/service from (to) related parties, financial transaction is transactions that are of a financial nature such as loans to (from) related parties, and compensation transaction is defined as the controlling shareholders' salaries, bonuses, and benefits. The results show that there is similar market response (CAR) to fiscal and financial deals but, on average, a lower (negative) market reaction when RPT is a managerial compensation scheme for a controlling shareholder. There is some evidence that the average CAR seems to be related to the type of transaction, suggesting that RPTs are complex mechanisms. In a study-using sample from publicly listed firms in Malaysia, [17] look into RPTs that needed independent advice and recurrent RPTs derived from circulars to shareholders. They find that RPTs are detrimental to shareholders and thus reducing firm performance, but the negative effect is mitigated with the presence of good governance.

Another set of studies rely on RPTs in corporate filings, which refer to the notification submitted to the stock exchange regarding the RPTs. Reading the filings allow researcher to evaluate the extensiveness of RPTs information [18]. By deriving data from filings of connected transactions, [18] and [19] are able to classify connected transactions into three categories: a) transactions that are a priori to result in expropriation (asset acquisitions, asset sales, equity sales, and trading relationships and cash payments), b) transactions that are likely benefit the listed firms (cash receipts and subsidiary relationships), and c) transactions that may have been driven by strategic rationales (takeover offers and joint ventures, joint venture stake acquisitions and sales). Reference [19] further categorizes these transactions into tunneling or propping activities. They find that there are more tunneling than propping in their sample of filings by Chinese listed companies. They also find that value destroying RPTs are accompanied by significantly less information disclosure as compared to the remaining

RPTs, suggesting that the controlling shareholders who tunnel assets may be manipulating the information disclosure for the purpose of concealing expropriation. While majority of firms in the sample experience a reduction in value at the announcement of RPTs, the reduction in value is not present in similar arm's length transactions. They further find that firms that voluntarily provide more information about the transactions earn positive excess returns.

Our final review is on studies that focus on specific types of RPTs or specific settings surrounding the disclosure of RPTs. Reference [20] only focuses on cases where a related party obtained a guarantee of repayment for a loan to the related party that was unrelated to the business activities of the listed firms. Their focus on related-party loan guarantee is substantiated by the cases of expropriation through loan guarantees in China in the period where the guarantees were permissible and issued by many listed companies in China (before any issuance of new related-party guarantees is prohibited by Chinese regulators in June 2000). They find that Tobin's Q, ROA, and dividend yield are significantly lower, and that leverage is significantly higher, for firms that issued related guarantees. Reference [21] refers to the manipulation of transfer price in RPTs to make inferences about earnings management through RPTs, as compared to other studies that plainly rely on volume of related sales or abnormal related sales as a measure of earning management. Based on the data from firms listed on Shanghai stock exchange that disclose gross profit ratios of RPTs, they find that the quality of governance plays a role in determining the used of manipulated transfer prices in RPTs. Reference [22] examines the value relevance of RPTs disclosures before and after the adoption of IFRS in Greece. Focusing on related sales of goods and sales of assets, they find that the adoption of IFRS is perceived to be effective at reducing the potential misuse of RPTs for earnings management purpose. The lower valuation of RPTs observed in the 2002 – 2007 sample is not observed in the period after the adoption of IFRS. Reference [10] examines the valuation of firms that disclose RPTs prior to the Sarbaney-Oxley Act ban on RP loans. They classify RPTs into three categories; loans, other simple transactions and complex strategic transactions. They also classify RPTs according to whether the transaction is with director, officer, and shareholder, or with unconsolidated investment of the firm. They find that RP firms have significantly lower valuations and marginally lower subsequent return than non-RP firms. Additionally, they find that market perceptions differ based on partitioning firms by RP transaction type and parties. Market views firms that disclose RP loans and other simple transaction with a director, officer, and shareholders negatively, but disclosure of complex RPTs and RPTs with firm investments is not associated with valuations or returns. In similar vein, [23] compare the value relevance of RPTs disclosure before and after the '2001 PRT Measurement Regulation' in China. The findings indicate that the regulation is perceived to effective by investors in controlling opportunistic earnings management behaviors by managers.

In general, research on RPTs has relied on various sources of RPTs information. Majority of the research focuses on RPTs disclosed in the annual reports, although there are more disclosures that can be derived from filings and circulars.

IV. ISSUES ON RPTs DISCLOSURE

The requirements for RPTs disclosure are set to inform shareholders on RPTs, for the purpose of protecting their interest. While firms generally comply with the disclosure requirement, there are issues surrounding such disclosure. The first issue is on the level of compliance with mandatory information and the practice of providing voluntary information. While reforms on accounting standards may improve the quality of disclosure on RPTs, there are concerns that firms adopt the standards at varying levels. In the case of the Philippines, [24] investigates the extent of compliance with the disclosure requirement of IAS24. Using data on related party relationships, related party transactions, and compensation of key management personnel, the average disclosure for RPTs is 0.70 with the lowest at 0.33 and the highest at 1. Thus, there is deficiency in the compliance of disclosure requirements per IAS 24, especially related to disclosures on doubtful accounts, other long term benefits, and termination benefits. Meanwhile, firms may opt to provide information beyond the mandatory requirement. Reference [25] investigates the voluntary disclosures of the pricing methods of RPTs, in the setting where the regulations encourage but do not require listed companies to disclose pricing policies and related details. They find that earnings management and its incentives, board composition, and ownership structure significantly influence the voluntary disclosure decisions of managers.

In similar vein, the issue of the variation in the level of compliance exists in the context of complying with listing requirements. Reference [24] compares some relevant Paragraphs of Bursa's Listing Requirement to a series of announcement of companies and various trails of transactions. Based on her analysis, she raised up several peculiarities. For example, she cited a case where a person is a director or chairman on both sides of the transaction but doesn't own any shares in either company, such transaction is not considered RPT. There is a case where firms can simply state that they are not unable to disclose an exact date of a contract due to confidentiality. The details of the valuations are also neglected in the cases where the purchase consideration was 'negotiated on a willing buyer, willing seller bases. While a higher level of transparency is required for transactions involving related parties, the peculiarities that exist in practice raised the issue regarding the motivations and incentives behind disclosure or non-disclosure of RPTs.

Secondly, comparison between RPTs of information from different avenues indicates that the level of disclosure differs. One of the main reasons would be that while the accounting standard is very much a principle-based approach, the stock exchange regulations are rule-based approach. Reference [10] indicates that many companies do not report RPTs in the financial statement, but choose to disclose RPTs in their annual proxy statements. The differences in the disclosure can be explained by materiality based on monetary levels. Reference [11] reviews RPTs disclosure in the annual reports and proxy filings of the S&P 1500 firms. They find that a majority of companies (66 percent) disclose RPTs information only on their proxy statement, 20 percent disclose all RPTs in their footnotes, and 12 percent reports unique RPTs in both the proxy statement and footnotes. This

appears to happen because more specific guidance is provided in SEC regulation as compared to the accounting standards on RPTs. Comparison between footnote firms and proxy firms indicate that material considerations drive the differences in RPTs disclosures. More common and less complex RPTs are more likely to receive proxy statement disclosures, as compared to less common and more complex RPTs.

Thirdly, not all RPTs are of similar nature. For example, analysis on RPTs in the proxy statements shows that RPTs vary according to transaction type [10]. Different types of RPTs require different level of disclosures, especially when the disclosure is associated with different underlying incentives and has differential effect on the firm. As discussed above, [19] which categorize RPTs into tunneling or propping activities indicate that disclosure of information differs between those two types of transactions. They suggest that manipulation of information disclosure may be used by controlling shareholders to conceal expropriation. Reference [10], which classifies RPTs into loans, other simple transactions and complex strategic transactions, find that market perceptions differ according to types of RPTs and the related parties. They find that market views firms that disclose RP loans and other simple transaction with a director, officer, and shareholders negatively, but disclosure of complex RPTs and RPTs with firm investments is not associated with valuations or returns. Reference [14] finds that receivables and payables from RPTs exhibit a significant positive relationship with performance, and sales and purchases of goods from RPTs exhibit a significant negative relationship with performance. They conclude that RPTs affect enterprise value, but cannot be used to estimate the optimal results because there are many types of RPTs that typically are conducted through complicated process. Hence, it becomes quite difficult for outsiders to accurately identify the effect of RPTs on corporate value. Reference [16], which classifies RPTs into fiscal transaction, financial transaction, and compensation transaction, finds that the average CAR related to the type of transaction. They suggest that RPTs are complex mechanisms.

Overall, there are variations in the level of disclosure of RPTs information. Prior research that only relies on the monetary value of RPTs neglects the fact that non-monetary information provides more details about such transaction. This is a concern because non-monetary information may be required to distinguish whether RPTs are value-enhancing or value-destroying activities. We recommend future research on RPTs to consider non-monetary information, such as the related parties involved in the transaction, in measuring RPTs. Further, the level of RPTs disclosure is influenced by the managerial incentive behind such disclosure. As a higher level of transparency is required for transactions involving related parties, we recommend future research to develop a voluntary disclosure index for the purpose of measuring the breadth and depth of RPTs information [26].

V. CONCLUSION

Our study reviews existing regulation that surrounds RPTs disclosure practise by looking into the accounting standards on RPTs, listing requirement, and security commission's

guidelines. We also examine measures of RPTs being used in empirical research that analyzed the economic consequences of RPTs information. We find that the level of RPTs disclosure varies, and the variation sare due to the different nature and types of RP transactions. Our review contributes to understanding on the quality of financial reporting quality, generally, and RPTs information specifically. We propose that research on RPTs should apply content analysis using a voluntary disclosure index to understand more about the breadth and depth of the RPTs information.

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