

Motives and Consequences of Related Party Transactions Before Initial Public Offerings

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1. Introduction

In this research paper, we examine whether firms that conduct initial public offerings (IPOs) use related party sales (RPS) to avoid reporting losses and earnings declines before the offering. Related parties include founders and top management of the firm about to issue shares via an IPO (referred to as 'IPO firm' hereafter), as well as other firms to which the IPO firm is related as an investor or as an investee--holding companies, associates and joint ventures, subsidiaries, and group companies. The distinguishing feature of RPS is the ease with which they can be executed and the flexibility they offer to increase earnings. Consider the case of sale of goods to a related party as an example. Here, both the transaction quantity and the unit price are under the control of that party because she is on both sides of the transaction. Additionally, in contrast to normal arm's length sales, search costs and time, marketing costs, and customer retention costs are eliminated.

The advantage of ease and flexibility might suggest that RPS would be exploited to the hilt by firms to boost profits before issuing shares via an IPO. However, excessive RPS-based earnings management is unlikely to occur before IPOs, for several reasons:

- Potential investors are likely to interpret RPS as evidence of opportunistic behavior by insiders. This negative perception could lower IPO prices.
- RPS may be viewed as posing a higher collection risk than would sales to non-related parties, again leading to downward valuation.
- It would be difficult for firms to signal credibly about the quality of RPS.
- Governance mechanisms such as auditors and independent directors could deter insiders from engaging in these transactions.

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Finally, in India, an additional deterrent is that the nature and the amount of RPS is tabulated in a transparent manner in the IPO prospectus. Hence, investors will be able to make an unambiguous assessment of the impact of RPS on bottom-line profits. Overall, managers will choose a level of RPS that balances the ease and flexibility advantage against potential downward valuation because of negative perceptions.

2. Hypotheses

While we do not make unambiguous predictions about the use of RPS by the entire sample of firms about to issue shares via IPOs, we predict that two sub-groups of these firms that will have relatively higher amounts of related party sales (RPS) are:

- (a) Firms that wish to avoid reporting either a loss or a profit decline.
- (b) Firms with high levels of promoter ownership.

Prior research in psychology finds that investors and other stakeholders use simple heuristics to judge firm performance. Examples of such heuristics are: “Has the firm made a profit?” and “Has the firm’s profit increased compared to that of last year?” Firms that achieve profits and profit improvements are valued higher than firms that incur losses or experience earnings declines. Based on this expectation, our first prediction is that IPO firms will be motivated to use RPS to attain these goals.

Our second prediction is that RPS will be higher in IPO firms that have high levels of promoter ownership. This prediction would be consistent with the argument of Leuz, Nanda, and Wysocki (2003) that insiders would use earnings management to conceal poor performance in an attempt to protect their private control benefits. In an IPO setting, by managing earnings upward via RPS, promoters can increase the offer price and thus reduce the number of new shares to be issued. This would allow them to preserve their control over the firm.

3. Institutional Setting

Our study of RPS before IPOs is novel because of the uniqueness of the setting in which we conduct the study. The Indian institutional setting has three features which are likely to increase managerial motivation to manage earnings upward before IPOs.

First, regulations of the Securities Exchange Board of India (SEBI) require that a firm applying for listing should have a track record of profitability in at least of three of the five years before the IPO. Thus, firms have a strong motivation to manage earnings and show that they have avoided

losses--to satisfy listing requirements. In contrast, most developed countries, including United States and United Kingdom, do not require firms that go public to report pre-IPO profits. Loss-making firms can and do go public in these countries.

Second, the type of investors to whom IPO shares are to be allotted in book-built issues is determined by SEBI regulations. Book-built issues are IPOs where investment banks appointed by the IPO firm gather information from potential investors to set the offer price for the IPO. According to the SEBI regulations, in a book-built issue, shares are to be allotted to three types of investors--retail investors, non-institutional investors, and qualified institutional investors in the ratio of 35:15:50. The presence of a significant proportion of retail and non-institutional investors, who are considered less sophisticated than institutions, increases the chances that earnings management will be ignored when the offering is priced.

The third feature of interest is that most pre-offering shareholders are subject to a three-year mandatory lock-in after the IPO, that is, they are not allowed to sell their shareholdings for up to three years after the IPO. Given this restriction, the amount raised from the IPO becomes even more important to their wealth, increasing the incentive to manage earnings before the IPO.

4. Results

We conduct our analysis with a sample of 253 Indian IPOs from the years 1999-2009. Based on manually-collected data from IPO prospectuses, we document that, as a fraction of firm sales, mean RPS increases from 7% three years before the offering to 9.5% in the year before the offering. Additionally, mean related party expenses as a fraction of sales declines from 6.1% to 4.4% over this period. Combining the effect of sales and expenses, the profit from these transactions as a fraction of sales increases from a mean of 0.9% to 5.1% over the three years before the IPO.

We estimate cross-sectional regressions of related party sales (RPS) in the year before the offering on measures for the incentive to avoid a loss and the incentive to avoid earnings declines, insider ownership, and several control variables. We find that IPO firms use RPS to avoid earnings declines. This finding obtains for RPS aggregated across all parties, as well as for sales to two groups – key managerial personnel and corporate related parties, a group consisting of holding companies, associates and joint ventures, and group companies. We find that inter-corporate sales are employed to avoid losses, but sales to key managerial personnel are not. Contrary to our expectation, we find no evidence that RPS is increasing in the level of inside ownership.

In supplemental analysis, we find that pre-IPO RPS is of low quality. To measure pre-IPO RPS

quality, we correlate it with subsequent cash flows. High quality RPS should translate to cash collections; in contrast, low quality RPS would not be realized as cash. We find that pre-IPO RPS is not significantly related to operating cash flows both in the year in which the offering is conducted and in the following year. We also assess the impact of RPS on IPO firm valuation, we estimate regressions of market capitalization based on the IPO offer price and the first-day closing price on RPS and standard control variables from the IPO valuation literature. Our evidence indicates that consistent with RPS being unrelated to future cash flows, valuations are not significantly related to these sales.

5. Conclusion

Our study contributes to the academic literature on earnings management around IPOs. Unlike most studies on earnings management around IPOs, which at most analyze data for the year before the offering, we provide descriptive evidence on RPS for three years before the offering. Our work complements two studies on the use of RPS by Chinese IPO firms - Aharony, Wang, and Yuan (2010), and Chen, Cheng and Xiao (2011). Both these studies emphasize correlations between RPS and earnings to conclude earnings management. In contrast, we hypothesize and evaluate if meeting targets and increases in inside ownership induce earnings management via RPS. Further, both the Chinese studies examine only RPS between the IPO firms and their holding companies. Our study examines a broader set of related parties and distinguishes between key managerial employees' RPS and inter-corporate RPS. Our study also adds to a growing literature on related party transactions (RPTs) by mature listed firms (Jiang, Lee, and Yue, 2010; Jiang and Wong, 2010; Kohlbeck and Mayhew, 2010). Compared to RPTs of listed mature firms, their usage by young IPO firms and their consequences for valuation and future performance has received very little attention.