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Women on Audit Committees and the Relationship between Related Party Transactions and Earnings Management: Evidence from India

S.G. Badrinath and Akanksha Jalan[10]

1. Background

Related Party Transactions (RPTs) continue to be rated as the biggest threat to Indian corporate governance today (OECD, 2014). Under Indian Accounting Standard – 18 on Related Party Disclosures, parties are said to be related "if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions".

While RPTs are looked upon with scepticism globally, the unique ownership structure of Indian firms makes them even more vulnerable to abuse. The Indian corporate sector is characterised largely by the presence of family firms, often organised in the form of business groups. More than 90% of listed firms in India are "Controlled Firms." The main distinguishing feature of the controlled firms is that the share ownership in these firms is concentrated in the hands of an individual, family or other investor group, domestic or foreign parent, or the State which enables them to assume directly or indirectly management control of the business. The Indian corporate sector is characterised largely by the presence of family firms, often organised in the form of business groups. Business groups in India may be organised in the form of pyramids through chain holding that allows the ultimate owner (the controller or promoter) to retain control and transfer assets across different firms owned, to his own best advantage and often at the expense of minority shareholders. In India, roughly 20% of the voting equity is generally adequate to control firms since it is virtually impossible for anyone to coordinate and get together higher number of votes from out of the remaining 80% to challenge the controllers. Among the main reasons contributing to this predicament are:

a) the geographical dispersion of small shareholders,

[10] S.G. Badrinath (badrinathsg@iimb.ac.in) is Visiting Faculty of Finance and Accounting at IIM Bangalore and Akanksha Jalan (akanksha.jalan10@iimb.ernet.in) is Assistant Professor of Finance and Accounting at the Rennes School of Business, France. The authors acknowledge with gratitude financial support from the NSE-IGIDR Corporate Governance Research Initiative 2015-16. The usual disclaimer applies.

b) the insignificant size of holding of small shareholders,

c) high costs of monitoring corporate developments,

d) even plain indifference of shareholders

Many promoters in India have been taking advantage of this situation to gain and retain control of their firms with significantly smaller than majority shareholding (NSE Quarterly Briefing, June 2017). [11]

The Satyam scandal in India highlighted serious inadequacies in the regulation of RPTs in India and prompted reform in that area. While regulators recognise the fact that RPTs could be employed for several reasons including genuine business ones, the difficulty in their identification and in the determination of arms-length values makes them a greater cause of concern for listed Indian firms.

2. Research Question

The relationship between the use of RPTs and earnings management objectives of corporate managers is a well-researched area. In its most common meaning, earnings management refers to the act of opportunistically reporting accounting numbers with a view to either smooth income over time or achieve specific targets such as meeting analyst expectations, receive import relief, earn performance bonus etc. (Healy & Wahlen, 1999). Interestingly, papers have found evidence of 'tunnelling' in Indian business groups, which is also consistent with the use of RPTs to achieve earnings management (Bertrand, Mehta, & Mullainathan, 2002). Tunnelling is a specific form of RPT that involves transfer of profitability from a firm in a business group in which the majority shareholder has low-cash flow rights to another firm in the same business group where he has higher cash-flow rights, at the expense of the minority shareholder.

We extend the RPT-earnings management argument by conducting research on how gender diversity affects this relationship for Indian firms, where the use of RPTs is rampant and recent regulatory reform has mandated the induction of at least one woman director on the boards of listed companies. We choose to study the impact of gender-diversity on audit committees, rather than at the board-level because the provisions of the new Companies Act, 2013 have cast onerous responsibility on the audit committee, in terms of identification and approval of RPTs that the management may wish to undertake. The audit committee is a specialised committee of the board which is entrusted with

[11] https://www.nseindia.com/research/content/res_QBJune17.pdf

the responsibility of overseeing the quality of overall financial reporting process within the firm. Starting April 1, 2014 (also the start of our sample), no RPT can be initiated unless approved by this committee, granting it absolute power over such transactions. This is in contrast to its erstwhile powers which included a mere review of the firm's RPTs, once they had taken place.

In this paper, we first examine whether RPTs serve as a tool for earnings management in listed Indian firms. We then assess the impact of gender diversity on the aforementioned relationship. This research question is particularly important in the contemporary Indian corporate scenario where regulators are leaving no stone unturned to enable women directors to break the glass ceiling. SEBI, the Indian capital markets regulator, has mandated the presence of at least one woman director on the boards of all listed firms, with effect from March 31, 2015. However, given the family-dominated businesses in India, one suspects that most firms will attempt to comply in letter of the new law rather than in spirit, by nominating a woman member of the family.

3. Hypotheses

Gender studies document higher moral standards (Bernandi & Arnold, 1997), greater risk-aversion (Barber & Odean, 2001; Estes & Hosseini, 1988) and greater sensitivity to ethical concerns (Gilligan, 1977) for women, on an average, when compared to their male counterparts. There exists a well-developed literature on the relationship between women directors and earnings management (Srinidhi, Gul, & Tsui, 2011; Thiruvadi & Huang, 2011) and between women directors and greater accounting conservatism (Francis, Hasan, Park, & Wu, 2015; Peni & Vahamaa, 2010). Most of these studies document that women directors are associated with lower accrual-based earnings management.

As is common in this literature, by gender-diverse committees, we imply committees that have at least one woman on the audit committee. Consistent with the large corporate finance literature that examines gender differences in corporate behaviour, we expect gender-diverse committees to alter the RPT-earnings management relationship. If women directors are indeed more risk-averse and conservative as the gender-differences literature documents, we expect to find that gender-diverse audit committees constrain the use of RPTs as the means to achieve earnings management. This leads to the hypothesis we test in the paper:

> *Gender-diverse audit committees (with one or more women on board) could result in greater conservatism in approving RPTs, particularly those that appear, prima facie, more prone to earnings management, in their the opinion of the women audit committee members. We expect such behaviour to alter the RPT-earnings management relationship.*

4. Data and Sample

We use a sample of the 500 largest listed Indian firms that comprise the CNX-500 on the National Stock Exchange, starting April 1, 2014, the earliest date for which the provisions of the New Companies Act became applicable. We make exclusions for utilities and financial firms, which is a fairly standard practise in accounting and corporate finance studies. Data for RPTs, audit committee composition etc. are obtained from the CMIE Prowess database, which is the largest repository of financial information for private Indian firms.

5. Concluding Remarks

Our results fail to find evidence of any relationship between the presence of women on the audit committee and the relationship between RPTs and earnings management. We attribute this to the small size of the sample used for this study. The small sample size had to be chosen owing to the hand-collected nature of the corporate governance variables used for our empirical tests. Hand-collection from the annual reports is a time-taking exercise, owing to the difference in reporting styles by different companies.

However, our results present weak evidence that the presence of promoters on the audit committee results in higher earnings management. The relationship is considered weak given the level of statistical significance that we obtain. To the best of our knowledge, this is the first paper to document this finding in the Indian context.