Managing Earnings Through Related Party Sales Prior to IPOs – Evidence from India

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Introduction

Initial public offerings (IPOs) are transformational events for private companies. The period leading up to an IPO is marked by heightened scrutiny from regulators, analysts, and potential investors. While the practice of earnings management—particularly through accruals—has been widely studied, our paper investigates a more opaque and potentially insidious form: related party transactions (RPTs), specifically related party sales (RPS). Using a unique hand-collected dataset of 253 Indian IPOs from 1999 to 2009, we evaluate whether firms inflate earnings using RPS and assess the financial and valuation consequences of such practices.

India presents an ideal setting for this investigation. SEBI mandates profitability in three of the five years preceding an IPO, pushing promoters to paint a healthy financial picture. Furthermore, the Indian IPO landscape is characterized by a high presence of retail and non-institutional investors—who are arguably less adept at parsing financial subtleties. Finally, post-IPO lock-ins prevent promoters from liquidating a large portion of their holdings, incentivizing them to maximize the offer price. These factors create strong motivations for earnings manipulation before going public.

Related Party Transactions as a Mechanism for Earnings Management

Related party sales offer a convenient vehicle for boosting pre-IPO earnings. Unlike accruals, which are tied to accounting estimates, RPS involve actual transactions—albeit non-arm's-length. Promoters and key managerial personnel can direct sales to subsidiaries, joint ventures, and other affiliated entities at inflated prices or volumes to enhance top-line and bottom-line figures. In contrast to typical operational sales, RPS are easier to orchestrate, less transparent in their intent, and potentially more impactful on headline financials.

However, these tactics are not without cost. Disclosure norms under Indian Accounting Standard 18 (now Ind AS 24) require firms to detail related party transactions in their IPO prospectuses. This transparency offers investors the opportunity to evaluate the nature and materiality of such transactions. Yet, whether these disclosures affect valuations or post-IPO performance remains an empirical question we aim to answer.

Our study focuses on three primary issues:

1. **Motives**: Do IPO firms use RPS to avoid reporting losses or earnings declines?
2. **Ownership Effects**: Is the propensity to use RPS higher in firms with greater insider ownership?
3. **Consequences**: What are the implications of pre-IPO RPS for firm valuation and future operating performance?

Methodology and Findings

We manually extract RPT data from IPO prospectuses, analyzing five years of disclosures for each firm. These transactions are classified by counterparty—key managerial personnel (KMP), subsidiaries, joint ventures, and group firms—and transaction type (sales, loans, dividends, etc.).

We then conduct regression analyses to identify statistical relationships between RPS and key variables: pre-RPS earnings, ownership structure, firm governance, and post-IPO performance. Importantly, we distinguish between RPS aimed at KMPs and those with corporate affiliates to better understand the nature of these transactions.

We find a steady and significant increase in RPS as the IPO date approaches. On average, RPS as a percentage of total sales rise from 7.0% three years before the IPO to 9.5% in the year immediately preceding it. Simultaneously, related party expenses as a percentage of sales decline from 6.1% to 4.4%, suggesting that RPS are being used to not only inflate revenue but also profit margins.

Combined, the pre-IPO profit margin attributable to related party transactions increases from 0.9% to 5.1% of total sales—highlighting a clear earnings management motive.

Consistent with our first hypothesis, firms strategically use RPS to avoid reporting losses before the IPO. Our regression analysis shows a statistically significant positive relationship between the likelihood of a pre-RPS loss and the volume of RPS executed. In simpler terms, when a firm's organic earnings fall short, it turns to RPS to close the gap.

Evidence for using RPS to avoid earnings declines is weaker and less robust across specifications, indicating that while avoiding outright losses is a strong motivator, managing for stable earnings trajectories may be a secondary concern.

We also find that the higher the insider ownership at the time of IPO, the greater the use of RPS. Promoters with significant skin in the game—who cannot immediately sell their holdings due to SEBI's lock-in requirements—have strong incentives to maximize the IPO valuation. Inflated earnings through RPS can help achieve this goal, even if it means sacrificing future cash flows or investor trust.

Interestingly, this ownership-driven effect is more pronounced in transactions with corporate entities than with individual KMPs.

RPS involving corporate entities (subsidiaries, joint ventures, group firms) are the main vehicles for earnings management, not those involving KMPs. This suggests a deliberate strategy to distance questionable transactions from individuals, perhaps to minimize investor backlash or scrutiny. Moreover, corporate counterparties are better positioned to engage in large transactions and can potentially justify such dealings as operational.

Our analysis of business group (BG) firms—common in India's corporate landscape—reveals a duality. BG-affiliated IPO firms engage in more RPS overall, consistent with the "tunneling" hypothesis, where controlling shareholders siphon value from minority shareholders. However, these firms are less likely to use RPS to avoid earnings declines, possibly due to reputational concerns affecting the larger business group.

This nuanced behavior implies that while BGs facilitate RPTs, they may also moderate the extent of earnings manipulation to protect long-term group reputation.

Perhaps most critical for investors is our finding that pre-IPO RPS do not lead to improved post-IPO operating cash flows. In fact, in the year of and the year after the IPO, firms with higher RPS show weaker operating cash performance. This suggests that RPS are low-quality earnings—a red flag for fundamental investors.

Robustness checks using changes (rather than levels) in cash flows and RPS confirm this result. The absence of future cash realization undermines any claims that RPS reflect real economic activity or business synergies.

Do investors see through this earnings management? Our valuation models indicate that neither the offer price nor the first-day closing price significantly reflects the level or change in RPS. This suggests that markets—especially in the context of India's retail-dominated IPOs—may not effectively penalize firms for pre-IPO RPTs.

In short, promoters may get away with inflating earnings via RPS without facing valuation discounts at the IPO stage, though this may lead to post-listing underperformance as reality catches up.

Implications for Investors

The implications of our findings are particularly relevant for the investment community:

1. **Due Diligence Must Go Beyond Headline Numbers**: Investors, especially retail participants, must scrutinize the notes to financial statements in IPO prospectuses. Related party transactions are not inherently bad, but a spike in RPS close to the IPO should trigger deeper inquiry.
2. **Corporate Governance Red Flags**: Firms with high insider ownership and complex group structures are more likely to engage in earnings management through RPTs. While these structures offer operational advantages, they also pose governance risks.
3. **Beware of Unsustainable Earnings**: A strong pre-IPO earnings story, unsupported by operating cash flows, may not be indicative of long-term value. Investors should complement traditional valuation metrics with assessments of earnings quality.
4. **Policy Recommendations**: Regulators might consider enhancing disclosures around the nature, pricing, and terms of related party sales, perhaps even requiring independent fairness opinions for large pre-IPO RPTs.

Our evidence points to a clear and concerning pattern: Indian firms frequently use related party sales to manage earnings ahead of their IPOs, particularly to avoid losses and boost valuations. While these tactics may benefit promoters in the short term, they pose risks to long-term investors—particularly retail participants who may lack the tools to see through these practices.

As India's capital markets evolve and mature, we hope this research will inform more rigorous investor due diligence, foster better corporate governance, and prompt thoughtful regulatory responses to protect investor interests.