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Related Party Transactions and Firms Financial Performance

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Abstract

The study investigated related party transactions and firm's financial performance using Secondary data obtained from Nigeria stock Exchange. We tried to determine whether RPT is used by firms to manipulate and bloat Return on Asset, Return on Equity and Earnings per share of manufacturing firms. RPT was subjected to Hausmann test for selection of appropriate model and regressed against performance variables. Test of causality was conducted to determine whether causal relationship exist amongst variables of study. Result showed RPT has no significant effects on ROA and EPS and not used to manipulate ROA and EPS. Conversely, RPT has significant relationship with ROE without any causal relationship which may be attributable to the shareholding structure of the firms. The study confirmed positive relationship of RPT with ROA, ROE and EPS implying that increases in RPT increases performance and in contrast decreases in RPT decreases performance. Based on findings, we concluded

that firms are currently not using RPT to bloat earnings but probably use it to enhance its effectiveness in collaboration with efficient transaction hypothesis. However, positive relationship espoused by the study indicates its potential of being used for manipulative motive.

Introduction

Accounting communicates information about economic activities of a firm to interested parties. There is however sustained controversy about the reliability and validity of accounting information provided through financial reports. The reason is not farfetched. Corporate failures such as the case of Cadbury, Intercontinental bank, Oceanic and a myriad of financial institutions in Nigeria which collapsed due to falsification of accounting reports weakened users' confidence and reliance leading to general apathy and non-reliance on accounting reports. The spiral effect was the near collapse of the Stock Market as share prices tumbled downwards and investors lost confidence and valuable investments. The echo of accounting fraud reverberates globally. The intent of these frauds is to present a falsified report to deceive the users thus creating a large asymmetry of information that affects plausible decision making. Related party transactions were fingered as one of the tools used to perpetrate these frauds thus exposing the inherent risk associated with it. A firm primarily consists of shareholders or its affiliates, directors, Managers, principal officers and employees. A transaction that takes place between parties to the firm is referred to as related party's transactions. IAS 24 defines Related party transaction (RPT) as "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged" This definition encompasses controlling shareholders, directors and groups with influence over the firm (subsidiary, associates, joint venture, affiliates, and associated family members). A related party could engage in transactions under any form with one another and under any economic concept. The implication is that a related party may use these transactions to transfer resources in or out of the firm.

Existing literature recognizes two perspectives to related party transactions. RPT could either be detrimental to shareholders or it could be beneficial by representing a strategic economic decision by the company and therefore increases shareholders value (Gordon et al 2004). The first perspective views it as conflict of interest between the principal and agent and is embedded in the agency theory and leads to exploitation of firm's resources. This is otherwise referred to as tunnelling or conflict of interest and is hazardous to the interest of shareholders. Conversely, the second perspective recognizes it as the genuine efforts of the Managers and considers these dealings as sound business exchanges fulfilling economic needs of the firm. This is referred to as 'propping or efficient transaction hypothesis. According to Ge et al. (2010) RPT can optimize internal resource allocation, improve return on assets and reduce transaction

costs for firms. Shan (2009) argued that appropriate related party disclosure helps to protect minority shareholders' rights. Peng et al (2011) observed that market reacts positively to the announcement of transactions when there is a transaction between the firm and controlling shareholders for firms in financial distress while Friedman et al (2003) showed that investors support the firm when there is a moderate adverse shock to ensure survival. Buysschaert, (2004) discovered that intergroup equity transactions create value for non-controlling shareholders. RPT provide a platform for transfer of resources between different stakeholders resulting in gains to some and losses to others (Agnes et al. 2010). This creates distortions in financial statements and information asymmetry. Identifying if RPT transaction is beneficial or detrimental to the firm is sometimes cumbersome. Prior empirical studies produced mixed results, for instance, the result from a study by Cheung et. al (2009) and Pizzo et. al (2013) are conflicting. This could be attributed to problem of identification and measurement of variables. Secondly, culture and geographical location may affect results thirdly, firm internal factors, external influences and regulatory framework may impact on results leading to conflicting findings.

These accounting frauds which dated back to the mid fifteenth century have presented a complex problem to standard setters, researchers, accounting practitioners and professionals globally. In an attempt to tackle the menace, specific accounting rules and standards have been issued at varied times by different countries until recently the convergence of standard through International Financial Reporting Standards (IFRS). Furthermore, corporate governance initiatives have been embarked upon to ameliorate the problem. Chien and Hsu (2010) found a positive moderating effect of corporate governance on the related transactions-firm performance relationship and deduce that presence of corporate governance could 'transfer' related party transactions 'conflict-of-interest' to be efficient

Past studies on the impact of RPT on financial reporting that were recently conducted were mostly carried out in European Countries. This highlights a major gap in the literature taking account of the differences that exist in culture, efficiency of legal system and economy between third world and developed countries. Secondly, there is conflicting results from the outcome of various empirical studies. This paper looks at related party transaction in the context of both conflict of interest and efficient transaction hypothesis and therefore the main objective of this study is to ascertain the correlation between RPT and firm performance. It will ascertain if accounting fraud has been perpetrated using related party's transaction to bloat financial performance variables (Return on Assets, Return on Equity and Earnings per share).

Theoretical Framework

Agency Theory

Agency Theory is embedded on the concept of 'principal-agent relationship wherein a party defines the duties and responsibilities of the other party while the second party (agent) discharges the responsibilities entrusted by the other party' The investor (principal), engages the services of the other party (agent), defines the terms of the service, duties, responsibilities and delegates the operation of the entity to the agent to perform tasks on their behalf. The theory proposes that parties are self-motivated and pursues self-aggrandizements. This assumption of self-interest dooms agency theory to inevitable inherent conflicts. The self-interested motives by parties' lead to a deviation of the agent from the set goal of the principal and even conflicts with expectations. The expectation is that agents will act to satisfy the interest of their principals. To confirm when an agent acts in the best interest of the owner or acting to the contrary, the standard of Agency Loss" is deployed. Agency loss is the disparity between the best possible expected consequences by the principal and the results derived from the acts of the agent. When an agent satisfies expected results of the principal, agency loss is zero; conversely an increase in the violation of principal agents' covenants increase agency loss. Prior empirical research suggests that agency loss is minimized when principal and agent goals are similar. This implies expectation of similar outcome by both parties'. Secondly, agency loss is minimized when the principal has full understanding of the agent activities and consequences of his actions. It must be clear to the principal if action of the agent best serves his interests. Bruce et al (2005) stressed that agency theory is based on the assumption that agents are motivated by self-interest and therefore strive to maximize their personal economic wealth. To mitigate these problems, agents must obliterate self-interest; execute tasks in a way to achieve congruence in wealth maximization for both parties. This necessitates 'standardization of agency duty because of the potential differences. An agent has a moral responsibility for her actions, which cannot be abdicated simply because she acts as an agent for another. It is this self-interest assertion that motivates agents (managers) to manipulate earnings to achieve desired goals which are myriads and according to the whims and caprices of the manager.

The Efficient Transaction Hypothesis

This is premised on assumptions that related party transactions encourage excellent business transactions and fulfils the economic expectations of the firm. It is presumed not hazardous to the firm in contrast to the conflict of interest hypothesis. The hypothesis predicts that RPT have the advantages that parties' representatives are appointed to board as members and this ensures improved co-ordination of activities, encourages familiarity amongst members and results in rapid feedback mechanisms,

insightful and reciprocal exchange of ideas that are not obtainable in arm's length transactions. It creates convenience, mitigates delays and compensates parties for increased risks. According to Coarse (1937) RPT mitigates transaction costs and overcome impediments impairing production. Prior empirical research lends credence to the advantages of RPT (Fan & Goyal 2006; Khanna & Palepu, 1997, Fisman & Khanna, 2004). Gordon *et al.* (2004) and Ryngaert & Thomas (2007) observed that RPT enhances speedy and reliable information to suppliers in contrast to that obtained from unrelated parties.

Empirical Review

Firms make use of RPT to improve their reported performance. RPT refers to a business transaction between a firm and its shareholders, directors and family members, subsidiaries or associates. The transactions are often not a product of negotiation, bargaining, haggling or at arm's length and not in the best interest of the business entity itself. It is therefore essential that awareness should be created for investors and other users of the financial statement. Transfer pricing can be used to massage income through inter-company transfer of earnings, loans and long lived assets. Despite IAS 24, firms desirous of hiding related party activities still find complex mechanisms to execute their intention, for instance, Enron which collapsed was revealed to have consummated numerous RPTs and financial statements could not expose the unseen effects of such activities. It is possible subsidiaries may have been awarded contracts without competitively bidding for the contract in competition with an entity from another group. Its shareholders may never know about such missed opportunities. A rich body of literature exists on impact of related transactions on firms. Cheung et. al (2006) observed that market price of shares of firms with huge RPT continue to fall up to twelve months after RPT disclosure indicating that investors penalize such firms for a long time after RPT reporting in financial statements. Kohlbeck & Mayhew (2010) confirmed that RPT disclosures have a potential negative impact on share prices of firms that disclose RPT in financial statements in contrast to firms that do not make such disclosures. Xiao & Zhao (2012) noted stock value decreases on RPT announcement. Cheung et al (2006) observed that firms purchase non-current assets at a higher price and dispose at a lower price amongst related parties when compared to similar transactions sold to outsiders through a bargaining process. This suggests assets are expropriated or transfer of resources from minority shareholders to major shareholders. Empirical studies indicate that Specific methods are used to tunnel and expropriate resources. These methods include unrelated third party sales deployed to tunnel resources (Wang & Yan, 2012), abnormal accruals involving the use of fixed rates to expropriate resources (Gordon & Henry, 2005), extension of loan guarantees to third parties which is defaulted and the loans become lost as funds are tunnelled out of the entity (Berkman et al 2009), loans are advanced at less discounted interest rate

without consideration to prevailing market rate (Shastri & Kable, 2003), executive compensation through which huge funds are paid to undeserving executives (Djankov et al 2008) and generous credits being advanced in periods of excess cash flow without observing sound credit advancement criteria (Jian & wong, 2004).

Methodology

The sample of the study consist of 35% of the population of manufacturing firms listed in food, beverage and pharmaceutical sub sectors of the Nigeria economy with complete data.

The independent variable in this study is related parties' transaction (RPT) measured as total of business transacted for firm i in period t between directors and related parties to the firm

The dependent variables in this study are financial performance variables Return on Assets (ROA) Return on Equity (ROE) and Earnings per share.

Model Specification

The functional relationship between the dependent and independent variable, the disturbance, co-efficient and intercepts for RPT and financial performance for the purpose of the research is as stated below:

FP $\qquad$ = $\qquad$ f(RPTXNS)

Fp $\qquad$ = $\qquad$ ROA, ROE and EPS

ROA $\qquad$ = $\qquad$ f(RPTXNS) $\qquad$ (i)

ROE $\qquad$ = $\qquad$ f(RPTXNS) $\qquad$ (ii)

EPS $\qquad$ = $\qquad$ f(RPTXNS) $\qquad$ (iii)

From the above functional relationship, the econometric models are specified thus

ROA $\qquad$ = $\qquad$ $\alpha_0 + \alpha_1$ RTPXNS+ U_1,t - $\qquad$ (iv)

ROE $\qquad$ = $\qquad$ $\beta_0 + \beta_1$ RPTXNS + U_2,t - $\qquad$ (v)

EPS $\qquad$ = $\qquad$ $w_0 + w_1$ RPTXNS + U_3,t- $\qquad$ (vi)

Using equations iv to vi above, the mathematical form of the models are specified as:

ROA $\qquad$ = $\qquad$ $\alpha_0 + \alpha_1$ RTPXNS $\qquad$ - $\qquad$ (vii)

$\hat{ROE}$ $\qquad$ = $\qquad$ $\beta_0 + \hat{\beta_1}$ RPTXNS $\qquad$ (viii)

EPS $\qquad$ = $\qquad$ $w_0 + w_1$ RPTXNS $\qquad$ (ix)

Where ROA is Return on Assets, ROE is Return on Equity and EPS is Earnings per share. On the other hand, RPTXNS is Related Parties Transactions,

Ui,t $\qquad$ = $\qquad$ Error term

$\alpha_0, \beta_0, w_o,$ $\qquad$ = $\qquad$ intercepts

α_1, β_1, w_1 $\qquad$ = $\qquad$ slope coefficients

From equations, vi to ix, it is expected that α_0, β_1 and $w_1 > 0$. It is also expected that an increase in related party transaction increases return on asset, Return on equity and earnings per share respectively.

Hypotheses

HO$_1$: Related Parties Transactions (RPT) do not significantly affect Return on Assets

HO$_2$: Related Parties Transactions do not significantly affect Return on Equity

HO$_3$: Related Parties Transactions do not significantly affect Earnings per share

HO$_1$: Related Parties' Transaction do not Significantly Affect Return on Assets.

Table 1: The Relationship between RPT and ROA;

Random Effect Model

Dependent Variable: ROA

Method: Panel EGLS (Cross-section random effects)

Date: 08/18/16 Time: 15:17

Sample: 2006 2014

Periods included: 9

Cross-sections included: 8

Total panel (balanced) observations: 72

Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.291759	0.356531	-0.818328	0.4159
RPT	0.493005	0.834172	0.591011	0.5564

Effects Specification

		S.D.	Rho
Cross-section random		0.000000	0.0000
Idiosyncratic random		2.614062	1.0000

Weighted Statistics

R-squared	0.004932	Mean dependent var	-0.185694
Adjusted R-squared	-0.009283	S.D. dependent var	2.610821
S.E. of regression	2.622911	Sum squared resid	481.5765
F-statistic	0.346941	Durbin-Watson stat	2.210348
Prob(F-statistic)	0.557746		

Unweighted Statistics

R-squared	0.004932	Mean dependent var	-0.185694
Sum squared resid	481.5765	Durbin-Watson stat	2.210348

There are two approaches to panel data analysis and they are fixed effect (FEM) and random effect models (REM). In order to apply the more appropriate approach; Hausman test must be conducted on the data set. The hypothesis is stated thus:

Ho: Random effect model is more appropriate than fixed effect model.

From Hausman test result (see appendix) p-value is 0.1794; this is far greater than 0.05 significance level and we accept assumption that REM is more suitable than FEM in analysing impact of RPT on ROA.

From table 1, regression of ROA on RPT using REM showed an intercept of -0.291759; this means average level of ROA is less than zero when RPT is zero. A positive relationship exists between RPT and ROA in terms of slope with coefficient of 0.493005, and p-value of 0.5564 which is far greater than 0.05 level of significance. Based on finding, the hypothesis that related parties' transactions do not significantly affect return on asset is accepted.

Positive coefficient means increases in RPT raise average level of ROA by 0.49. Coefficient of determination is 11 percent revealing RPT explain 11 percent of the variation in ROA.

HO₂: Related Parties' Transactions do not Significantly Affect Return on Equity

Table 2: The Relationship Between RPT and ROE;

Random Effect Model

Dependent Variable: ROE

Method: Panel EGLS (Cross-section random effects)

Date: 08/18/16   Time: 01:47

Sample: 2006 2014

Periods included: 9

Cross-sections included: 8

Total panel (balanced) observations: 72

Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.259965	0.265387	-0.979569	0.3307
RPT	3.420107	0.567536	6.026234	0.0000

	Effects Specification			
			S.D.	Rho
Cross-section random			0.327435	0.0341
Idiosyncratic random			1.741452	0.9659

	Weighted Statistics		
R-squared	0.344181	Mean dependent var	0.414446
Adjusted R-squared	0.334812	S.D. dependent var	2.122926
S.E. of regression	1.731438	Sum squared resid	209.8515
F-statistic	36.73677	Durbin-Watson stat	1.702911
Prob(F-statistic)	0.000000		

	Unweighted Statistics		
R-squared	0.343872	Mean dependent var	0.475833
Sum squared resid	215.8057	Durbin-Watson stat	1.655927

From Hausman test result (see appendix) p-value is 0.6569 which is far greater than 0.05 significance level, we accept the assumption REM is more suitable than FEM in assessing effect of RPT on ROE.

From REM result in table 2, regression of ROE on RPT showed an intercept of -0.26, which means average level of ROE, is less than zero when RPT is zero. A positive relationship exists between RPT and ROE in terms of slope with coefficient of 3.42 and p-value of 0.000. P-value of 0.000 is less than 0.05 level of significance, F-statistic = 36.74 > 3.84 or t-statistic = 6.0262 > 1.9939. Based on p-value of 0.000 being less than 0.05, we reject hypothesis that RPT do not significantly affect ROE. We conclude that RPT significantly affect ROE.

The positive coefficient means that every unit increase in related parties' transactions increases average level of return on equity by 3.42. The coefficient of determination is 34 percent which reveals that RPT explain 34 percent of the variation in ROE.

H0₃: **Related Parties' Transactions do not Significantly Affect Earnings per Share**

Table 3: The Relationship between RPT and EPS;

Random Effect Model

Dependent Variable: EPS

Method: Panel EGLS (Cross-section random effects)

Date: 08/18/16   Time: 01:50

Sample: 2006 2014

Periods included: 9

Cross-sections included: 8

Total panel (balanced) observations: 72

Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.395105	2.149134	1.579755	0.1187
RPT	1.465620	1.154520	1.269463	0.2085
	Effects Specification			
			S.D.	Rho
Cross-section random			5.936532	0.7633
Idiosyncratic random			3.305785	0.2367

Weighted Statistics

R-squared	0.022355	Mean dependent var	0.677154
Adjusted R-squared	0.008389	S.D. dependent var	3.331002
S.E. of regression	3.317001	Sum squared resid	770.1747
F-statistic	1.600656	Durbin-Watson stat	0.804527
Prob(F-statistic)	0.210006		

Unweighted Statistics

R-squared	0.031352	Mean dependent var	3.710417
Sum squared resid	3138.168	Durbin-Watson stat	0.197448

Hausman test result (see appendix) shows p-value is 0.224 which is greater than 0.05 level of significance. Based on result, we accept that REM is more suitable than FEM in analysing effect of RPT on EPS.

From REM result in table 3, regression of EPS on RPT reveal intercept of 3.4. This imply average level of EPS is 3.4 when RPT is zero. A positive relationship exists between RPT and EPS in terms of slope with coefficient of 1.47 and p-value of 0.2085 is greater than 0.05 level of significance. Based on p-value, we accept that RPT do not significantly affect EPS. Positive coefficient means increase in RPT increases average level of EPS by 1.47. Co-efficient of determination is 2.24 percent indicating RPT explain only 2.24 percent of variation in EPS.

Discussion

The following observations were made:

1) Positive relationship exists between RPT and ROA, ROE and EPS as denoted by coefficients and p-value is far greater than 0.05 level of significance. We conclude that related RPT do not significantly affect return on assets, return and earnings per share.

2) A positive relationship exists between RPT and ROE as shown by coefficient and p-value is less than 0.05 level of significance. This imply RPT significantly affect ROE.

Huang and Chia-Liu (2010) accounts receivable and accounts payable from RPT exhibit significant positive relationship with performance while sales and purchase of goods from RPT have significant negative relationship with performance. Rafizadeh (2016) revealed a significant relationship exist between RPT and firm's performance. Munir, Sosheen and Gell (2010) RPT have negative correlation with performance. Pozzoli & Venuti (2014) RPT and performance are not correlated and there is no

evidence of cause-effect relation and also concluded the existence of control mechanisms prevented earnings management, especially earnings smoothing. Tower, Rosmin & Mitchell (2010) found no significant relationship between RPT and profit. Kuan, Tower, Rumin & Van der Zahn (2010) no evidence of RPT with earnings management.

Our study collaborates Pozzoli & Venuti (2014), Tower et.al (2010) and Van der Zahn et.al (2010). The findings confirm no significant relationship between RPT, ROA and EPS. Our study also found significant relationship between RPT and ROE. This collaborates Jiang & Wong (2010) which found firms use RPT to manage earnings in order to meet ROE requirement. The test of causality reveals no cause-effect relationship. The implication is that significant impact of RPT on ROE may be caused by external factors. This requires further analysis as shareholding structure may have influenced result. This Study establishes direction of relationship between RPT with ROA and EPS. A positive co-efficient exist between RPT and ROA, ROE and EPS. This means though there is weak and insignificant relationship between RPT with ROA and EPS; rise in RPT increases ROA and EPS. Similarly, increase in RPT increases ROE.

The insignificant relationship between RPT and performance could be attributed to regulation and controls put in place by regulators. Also, management initiates instituted to curtail falsification of financial statements could be identified as probable factor responsible for mitigating the use of RPT to massage earnings in Nigeria.

Conclusion

The study examined RPT and tried to establish if it exerts significant effect on firm's financial performance variables; ROA, ROE and EPS. This was to enable us ascertain if manufacturing firms used RPT to manipulate performance. The research showed weak and insignificant relationship between RPT with ROA and EPS and showed significant relation with ROE. We attribute this finding on ROE to the shareholding structure and suggest further analysis which is not considered in this study. The test of causality also showed no cause-effect relationship. The implication is that manufacturing firms in Nigeria do not use RPT to bloat ROA and EPS. However, test result established a direction of influence between the variables of study with performance. A positive co-efficient exist between RPT and ROA, ROE and EPS. This Imply increase in any of the variables has potential of increasing firm performance although firms in Nigeria are presently not using the variable to manipulate earnings.

Future Research

Our study focused on related party transactions. It also attempted to establish level of effect of RPT on firm performance metrics Return on Equity, Return on Assets and

Earnings per share. Future empirical studies may examine other accounting manipulation variables on firm performance. Further studies could be conducted to establish if industrial structure affects firms' response RPT. This will help researchers to proffer industry specific solutions to accounting fraud and hence improve the quality of financial reports.

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