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# Related party transactions: Review of the literature

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## Abstract

Asian financial crisis has led many countries to perform related party transactions, which are transactions made by the firms to affiliated parties and often performed by controlling shareholders. The emergence of related party transactions cannot be separated from the existence of pyramidal ownership, where the controlling shareholder has several layers of ownership. Just as related party transactions can create a conflict of interest between the controller and the minority, the controller may transfer firms' resources or assets to a parent entity that is not normally listed on a stock exchange. Therefore, in our paper, we would like to discuss about different aspects and arguments on the impact of related party transactions. Prior studies provide various contributions, as one argues that related party transactions are part of an efficient contract, where the two connected parties have better information with each other due to the connection than the unaffiliated parties. On the other hand, several studies suggest that related party transactions have a bad impact and are full of expropriation of minority interests.

Keywords: Related party transaction, tunneling, propping, ownership

## 1. Overview of Related Party Transactions

Two decades ago, Asia was faced by a financial crisis that led to the collapse of the economy. Transfer of assets between connected firms in order to extract resources for the profit of shareholders (*tunneling*) controller is suspected to be the main cause of the economic crisis. This is also proved by family firms' flawed business model, which often carry out related party transactions. When the financial crisis took place amidst a falling exchange rate, firms with high debt levels failed to pay their debts, putting pressure on their affiliated firms who were guarantors of these debts. Furthermore, minority shareholders are in vulnerable conditions, while controlling shareholders try to save their wealth through *tunneling* such as unreasonable cash transfers, purchase of assets at unreasonable prices and the use of firm's assets to conduct bailouts to affiliated firms which are more profitable for controlling shareholders.

The emergence of related party transactions cannot be separated from the existence of pyramidal ownership where the controlling shareholder has several layers of ownership (Claessens et al., 2000; Johnson et al., 2000; La Porta et al., 1999; Lin et al., 2012; Riyanto and Toolsema, 2008). Multiple layers of ownership enlarge the difference between cash flow rights and control rights, which in turn will provide incentives for those controlling shareholders to tunnel. Controlling shareholders

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will transfer assets from firms with low-cashflow-rights with high-control-rights to firms with high-cashflow-rights in order to provide benefits (Claessens et al., 2002, 2000; Riyanto dan Toolsema, 2008).

On the other hand, although related party transactions seem detrimental to the interests of minority shareholders, related party transactions can also be propping. Firms in pyramidal ownership usually benefit from sharing risk with other firms in a pyramid using related party transactions in the form of propping to assist other firms in the same pyramidal ownership structure (Ferris et al., 2003; Khanna and Yafeh, 2007, 2005) the assistance provided can range from the allocation of shared assets, and assistance to improve income, to large-scale assistance to deal with critical situations such as bailouts (Jian dan Wong, 2010).

## 2. Definition of Related Party Transaction

The International Accounting Standard Board (IASB) defines the related party transactions as the transfer of resources, services, or obligations between affiliated/related parties regardless of whether or not there are fees to be paid or not related to the occurrence of the transaction. In addition, The Financial Accounting Standard Board (FASB) stated that the transaction was a related party transaction even though no accounting records. For example, firms can receive services from related parties without any fees, receipts, and accounting records. Therefore, to understand the transaction, it is necessary to first understand the meaning or definition of a firm that is categorized as a related party. The following Table 1 defines a related party while Table 2 gives an example of the related party transaction from the IASB and FASB.

Table 1. Definition of Related Parties.

| IASB | FASB |
|---|---|
| 1. Parties connected through firms control (parent firms, subsidiary) or parties that have joint control or parties with strong control over the firms.<br>2. Partner<br>3. *Joint venture*<br>4. Key Management<br>5. Close family or individuals related to points 1 and 4<br>6. Individuals related to points 4 and 5 who have significant influence or have significant *voting* rights in the firms.<br>7. Pension funds for employees of firms or related firms. | 1. Firms partner<br>2. Entities whose investments in equity will be accounted for using the equity method by the firms<br>3. Employee pension funds, *trusts* related to firms employees<br>4. Firms owner<br>5. Firms management<br>6. Family owner or firms management<br>7. Parties with significant influence in the firms |

Source: IASB and FASB

In Asia, foreign investors are tempted by the scale of firms that tend to be large and liquid where these firms are usually part of a large business group or are in pyramidal ownership. Uniquely, firms' ownership in Asia is dominated by family ownership and government ownership with a significant concentration. In firms controlled by families, management and executive positions are usually dominated by family members of the controlling conglomerate. Likewise, firms controlled by the government, especially BUMN, management and executive positions, will tend to be filled by people with political connections or even politicians themselves, especially for executive positions.

Table 2. Examples of related party transactions.

| IASB | FASB |
|---|---|
| 1. Purchase or sale of goods<br>2. Purchase or sale of property<br>3. Service<br>4. Rent<br>5. Research and development transfer<br>6. Transfer with license agreement<br>7. Transfers with financial agreements (including loans, equity etc.)<br>8. Guarantee and guarantee provisions<br>9. Settlement of obligations on behalf of the firms or other affiliated firms. | 1. Sales, purchases and transfers of individual properties<br>2. Acceptance of services includes accounting services, management, engineering and legal aid services<br>3. Use of property or equipment under a lease agreement<br>4. borrow borrow<br>5. Guarantee<br>6. Bank account maintenance fees<br>7. Intercompany billing<br>8. Completion of consolidated tax returns |

Source: IASB and FASB

The firm's affiliation is formed under the auspices of a business group or pyramidal ownership which has unwritten rules regarding affiliation between group members or pyramid members. Of course, due to the dominance of ownership by a certain group or individual, the tendency to exploit is very high. As the controller has an incentive to enrich himself and the high difference in *cash flow* and *control rights*, the control right over the firm targets high expropriation and ownership dominance. It makes the controller have the capability to expropriate at the expense of the minority interest of the firms, especially if the purpose of establishment or acquisition is a certain entity.

Although it has a bad impact, related party transactions are actually legal and can be used for certain purposes such as the efficiency of the horizontal production chain, where the controller has control over business entities in a production line from upstream to downstream. Based on recent law, related party transactions were regulated and recognized in both business law and tax law. With regard to accounting records, both domestic and international accounting standards also have their own recording systems. In addition, a system of control and supervision of related party transaction activities has also been developed to maintain good corporate governance and to reduce the adverse effects or impacts of these transactions.

Just as related party transactions can create a conflict of interest between the controller and the minority, the controller may transfer firms' resources or assets to a parent entity that is not normally listed on a stock exchange. This makes the allocation of existing resources in the expropriated firms inefficient. The firms become unable to use the resources or assets that have been transferred to the parent for profitable operations where in the end the minority suffers losses due to this. So that related party transactions that are considered to have a negative impact on the firms are usually categorized as related party transactions that transfer assets or resources out of the firms to affiliated firms.

On the other hand, related party transactions are also used to benefit a minority of firms, known as propping. The existence of group businesses or pyramidal ownership creates alliances between entities within the group that allow them to share risk and use group resources or assets to help less healthy firms. Although the actual assistance received may be part of the expropriation of other affiliated firms. With related party transactions propping into the firms, the minority will also benefit from the assistance from the business group. Furthermore, related loans obtained from business groups or other affiliated firms can also benefit minority shareholders. These loans usually have terms under more favorable market terms and therefore related loans can be made on under market conditions because the information asymmetry between borrowers and lenders is much lower. Thus, lowering borrowing costs (Rajan, 1992).

Table 3 is an example of a related party transaction based on potential losses and gains for minority shareholders. Further, after testing investor responses to the existence of related party transactions in Hong Kong, found that investors cannot predict the existence of expropriation in the firms (Cheung et al., 2006). The new investors can respond only when there is an announcement of a related party transaction and make corrections to the firms' valuation. As expected, related party transactions that have the potential to be used as an expropriation tool will be responded to with negative reactions in the market. Besides, investor responses tend to be positive although less consistent in receiving news about related party transactions that tend to benefit minority interests or *propping up*.

Table 3. Related party transactions based on potential expropriation against minorities.

| Transaction Type | Description |
|---|---|
| Related party transactions that have the potential to become *tunneling* | |
| Asset Acquisition | Transactions involving the acquisition of tangible and intangible assets to related parties |
| Asset Sales | Sales of assets which include tangible and intangible assets to related parties |
| Equity Sales | Sale of equity to related parties |
| Trade relations | Transactions that include the sale of goods and services to related parties |
| Cash Payment | Transactions involving direct payments to related parties including loans and cash assistance, as well as loan guarantees by the firms against loans to related parties |
| Related party transactions that have the potential to be propping | |
| Cash Receipts | Transactions that include direct cash assistance and loans from related parties to firms |
| Relations with Subsidiaries | Transactions between the firms and its subsidiaries which include acquisitions, sales, equity transactions and trading relationships |
| Related party transactions that tend to have strategic reasons and not expropriation | |
| *Takeovers* and *Joint ventures* | Cases where firms accept *takeover* and *joint venture offers* from related firms listed on the stock exchange and in order to form strategic alliances |
| *Joint venture* acquisition | Cases where a firm accepts a *joint venture* acquisition from a third party in a *joint venture* alliance. |
| *Joint venture* sales | Transactions, including the sale of the firms to a third party which is connected via *a joint venture* together |

Source: Cheung et al. (2006)

Further, Cheung et al. (2006) argue that investors are optimist about firms that have the potential to expropriate. Thus, they will only respond only when expropriation occurs. This phenomenon also occurs because the controlling owner tends to expropriate the firms when economic conditions are stable and do *propping* only when economic conditions are not healthy to save and stabilize the firms' financial condition.

## 3. Regulation and protection against the negative impact of related party transactions

There are two important considerations for investors to manage related party transactions. First, the access and ability of investors to monitor related party transactions in order to take the necessary steps, especially with regard to the revaluation of firms value. Second, if the related party transaction does have a negative impact on the interests of investors, then what mechanisms can be taken both before and after the transaction to reduce the negative effect of the related party transaction. However, these applicable rules only limit transactions with a certain minimum amount that varies from one country to another. So that in the future, it may not be able to fully overcome the negative impact of related party transactions and provide full information to the minority to make decisions because transactions under the provisions are not required to be reported or get approval from the minority.

Thus, it is necessary to properly identify some transactions that may not be published through the principle of transparency with regard to the minimum threshold for announcing related party transactions. The following are several categories of related party transactions that need attention for minorities because they are not transactions that are mandatory to be announced such as: i) related party transactions that are excluded from the announcement, ii) related party transactions that are excluded from reporting, and iii) related party transactions are exempted from obtaining approval from an independent director or commissioner before the transaction can be executed.

The exclusion of related party transactions below the minimum requirement to be announced is actually intended to reduce the cost of announcements to the firms and reduce the burden due to related regulations. While some countries usually require firms that carry out related party transactions to announce the transaction along with the terms and conditions of the transaction.

In addition, transactions with related parties that exceed the minimum announcement requirement must be approved by shareholders. Normally, minority shareholders or non-controlling shareholders will first identify which related party transactions are material and have an impact on the firms and minority interests. This identification can be regulated through regulations such as in Singapore, where this identification can improve the quality of supervision by minorities against firms. Further, the shareholders will seek the opinion of an independent commissioner or director regarding the transaction. However, directors who are prone to conflicts of interest are usually asked not to follow or provide recommendations to shareholders, as in Malaysia.

Reporting regulation of related party transactions with amounts exceeding the minimum reporting obligation limits varies from one country to another. But in general, announcements of these related party transactions must be announced immediately, a maximum of two working days as in Indonesia. Then, the related party transactions have to be reported in the financial statements along with the completeness of the report under the terms and conditions such as the number of transactions, the related parties involved and the nature of the relationship between the related party and the firms, to the nature of the transaction. The report will be displayed in the audited financial report, where the auditor will be fully responsible for the accuracy of the financial reporting.

Regarding the minimum reporting requirements in several countries, the nature also varies. Usually, some use a ratio approach where the minimum limit is based on certain ratios, such as transactions with total assets. There are also those who use a minimum limit of a certain amount or what is commonly called the amount approach. Furthermore, there are also those who use a hybrid approach where the approach used is a combination approach between ratio and sum approach.

## 4. Previous research on related party transactions

Previous studies provide some descriptions of the impact of related party transactions. The results of these studies vary, one argues that related party transactions are part of an efficient contract, where the two connected parties have better information with each other due to the connection than the

unaffiliated parties. On the other hand, several studies suggest that related party transactions have a bad impact and are full of expropriation of minority interests.

First, Gordon et al. (2004) using a sample of US firms for the period before the *Sarbanes-Oxley Act* (SOX), found related party transactions to be widespread and involve executives and non-executive board members equally. In addition, they found that related party loans were significantly lower than other non-lending related party transactions such as direct purchases or services. Further in their investigation of the relationship between related party transactions and corporate governance mechanisms (such as board characteristics, performance-based CEO pay, and external oversight) found that weaker corporate governance mechanisms were typically associated with a higher number of related party transactions. They also find that stock returns are negatively related to related party transactions. Also, they examine related transactions in the form of loans versus other types of related party transactions not considered in SOX and found a negative relationship between stock returns. So, they argue that related party transactions are a form of conflict of interest between managers/board members and shareholders, not as efficient transactions.

Then, according to Ryngaert dan Thomas (2012), related party transactions are a potential means of expropriating minorities through *self-dealing* transactions. By evaluating both ex-ante and ex-post-related party transactions, they find that related party transactions are associated with lower operating income and market performance. Firms with large, related party transactions also experienced a decline in share prices in the market. This is in line with the view of the expropriation theory that related party transactions tend to be used by the controlling shareholder to expropriate the minority in the firms.

Contrary, Wong et al. (2015) suggest that the previous literature provides evidence that tends to be mixed and relatively little about the economic consequences of related party transactions. Using a sample of firms listed in China, they find that sales to related parties increase firm's value. However, this increase in value does not occur for firms with (i) a large percentage of directors of controlling firms, (ii) high government ownership, or (iii) when incentives for tax avoidance are large. They also find that intragroup sales increase firm value in general, although using intragroup selling by firms' insiders removes value from minority shareholders. Taken together, their findings highlight the interaction between ownership structure and tax avoidance incentives in determining the economic consequences of related party transactions.

The other argued that state-owned banks in China provide related loans to other SOEs based on information that is not profit-maximizing but tends to maintain social stability and tends to help reduce the unemployment rate (Bailey et al., 2011). So that the tendency for borrowing firms to have poor financial performance with a bad credit risk level. They found that the market responded negatively to these loans, especially related to fellow SOEs, because they were not loans based on profit maximization motives.

Still, in China, Jian dan Wong (2010) used a sample of listed firms from 1998 to 2002, documenting that listed firms sustain earnings by using abnormally related sales to their controlling owners. The use of such related sales was also found to be more common among state-owned firms and firms located in low-income areas. They also find that these abnormal related sales are not strictly accrual-based but can also be cash-based, and they serve as a substitute rather than a complement to accrual management to meet revenue targets. Because these abnormally related sales can be cash-based. There are significant cash transfers via related loans from the listed firms to the stock exchange back to the controlling owner after *propping*. However, no cash transfers via related loans were found to be related to earnings management.

According to Friedman et al. (2003), in countries with weak legal systems related to the protection of shareholders and creditors, there are many *tunneling* activities carried out by controlling investors of public firms. However, they also help firms through propping in some conditions, where

they use their personal funds. The transaction also benefits minority shareholders. They provide evidence and models that explain the propping phenomenon. Controlling shareholders will help connected firms escape the snares of financial distress in an era of economic crisis through *propping.* On the other hand, when overall economic conditions are good, they will expropriate firms' assets through *tunneling* activities to gain profits. Such behavior will certainly increase the firms' risk and, overall will increase the probability of an economic crisis. In particular, they suggest that debt can encourage investors to propping. These findings may explain why emerging markets with weak institutions sometimes grow rapidly and why they also experience frequent economic and financial crises

In line with this, Peng et al. (2011) developed a model that in equilibrium, controlling shareholders have the right to choose whether to use *tunnel* or propping their firms depending on the potential loss and the benefit gained from control. Using China's related party transaction data, they test the hypothesis that when firms listed on the stock exchange are financially healthy, controlling shareholders will be more likely to conduct related transactions that are *tunneling in* nature. This evidence shows that firms experiencing a decline in stock prices due to the market reacting negatively to the announcement of this transaction which strongly support the expropriation hypothesis. They also found that all types of transactions in the sample could be used for *tunneling* or *propping* depending on the firms' financial situation. Finally, political connections are negatively related to the effect of market announcements on transactions. Overall, the analysis supports the model of Friedman et al. (2003) by providing clear evidence that propping and *tunneling* can occur in the same firms but at different times.

Further, Huang et al. (2012) investigated whether inefficient bank loans can reduce the borrower's firm value when controlling shareholders' takeover of minority shareholders' shares is a major problem. Using data from Chinese banks, they found that bank loan announcements result in significant negative stock returns for borrowing firms. In line with this takeover view, the negative stock price reactions that occur after bank loan announcements are generally concentrated in firms that are considered more susceptible to takeovers by controlling shareholders. They found evidence that a negative relationship between market reaction and firms' susceptibility to takeovers exists only when firms borrow from the most inefficient and low-reputation banks.

In many countries, banks provide loans to firms controlled by bank owners. As La Porta et al. (2003) examined the impact of related borrowing in Mexico, which are quite common (20 percent of commercial bank loans) and provided with better terms or conditions than long-term loans (4 percent lower annual interest rates). Related loans are also 33 percent more likely to default and have a lower recovery rate (30 percent less) than unrelated loans. Evidence from Mexico in the 1990s supports the view that related borrowing is a manifestation of expropriation in certain situations.

*Tunneling* and *propping* between firms listed on stock exchanges in China and their related parties from 2001 to 2005 also investigated by Guo and Ma (2009). Their study shows that controlling shareholders engage in tunneling and propping activities through related loans, even though tunneling loans turned out to exceed propping loans in both frequency and magnitude. The controlling pyramid ownership structure increases the rate of tunneling loans, while large non-controlling shareholders reduce tunneling loans. Controlling owners tend to divert less funds when the firm has better investment opportunities. On the other hand, with regard to government ownership, the results of their analysis were not found to have a negative impact on firms, where this result contradicts several previous studies. A high debt ratio is likely to increase the probability of tunneling activities, especially through related loans.

While previous findings suggest that investors do not appear to systematically ignore *tunneling* in firms, Lei and Song (2011) found that firm value (Tobin's Q and *Market to Book Value* ratios) is significantly lower for firms that carry out transactions with potential takeovers (*tunneling* related party transactions) in Hong Kong. In addition, cumulative abnormal returns (CAR)

were found to be lower for related party transactions whose disclosures are excluded and negatively related to several other types of related party transactions. Their findings indicate that firms use related party transactions with the exception of disclosure as a means of *tunneling*. These related party transactions can provide an overview of the firms' low quality of corporate governance because investors substantially discount the stock price of firms that carry out transactions with the potential for expropriation.

Furthermore, Habib et al. (2017) examine whether politically connected firms use related party transactions as a *tunneling* mechanism in Indonesia. The study was motivated by conflicting evidence in previous literature on the role of political connections and related party transactions. Using data from Indonesia, they document that politically connected firms use related borrowing to extract firms' resources for controlling interest, and this behavior is more common in government-connected firms. They also document that politically connected firms manage revenue to hide their *tunneling* activity. By documenting the role of related party transactions as a special channel through which connected firms take over resources, the study reinforces the argument that political connections and related party transactions are concurrent.

In Spain, the concentration of ownership is fairly common and state ownership is practically non-existent in related party transactions (Bona-Sánchez et al., 2017). They argued that more than half of the Spanish-listed firms perform related party transactions during the analyzed period. From the point of view of related parties in transactions, related party transactions between Spanish listed firms and their controlling shareholders account for 99.84% of the total related party transactions performed by Spanish listed firms. Their findings reveal that from a financial review, operating and investment-related party transactions have a negative impact and affect the value of the company because of the takeover effect where related party transactions are driven by *insider* opportunism. Regardless of these transactions' financial, operating, and investment dimensions, the motive for seeking profit by imposing losses on the minority. Thus, in a context where corporate governance is poor, with the potential for expropriation of minority shareholders' assets by controlling shareholders, related party transactions require special attention by regulators to enhance investor protection and market confidence to promote more efficient allocation of resources.

Yeh et al. (2012) also explore how corporate governance affects the level of related party transactions and how the motive for using related party transactions moderates these relationships in Taiwan, where firms ownership in general tends to be concentrated. The empirical results indicate that good corporate governance is effective in limiting related party transactions and provides evidence of a negative relationship between corporate governance on various sizes of related party transactions and across various types of RPT (related sales, loans and related guarantees). In accordance with the *propping* hypothesis, their study shows that the level of related sales is positively correlated with the financial condition of the firms that plan to issue seasonal equity in the next period and the condition of the decline in reported earnings. Further, in line with the internal capital market hypothesis, these findings also indicate that the level of lending and guarantees is negatively correlated with conditions of increased capital expenditure and an increase in net working capital. The empirical results provide partial support for the two hypotheses.

Then, Tambunan et al. (2017) try to analyze the determinants of related party transactions that affect firm value in several business sectors on the Indonesia Stock Exchange. The determining factors used in this study are the type of related party transactions, firms' size, debt to equity ratio, and the crisis period. Their research used panel data with a quarterly time period from 2006 to 2013. The sample was determined purposively, focusing on firms' typology, namely firms in three business sectors representing three layers of market capitalization. The results showed that related party transactions: sales and revenues as well as purchases and expenses had a significant positive effect on firm

value. Transactions related to loans, receivables, *tunneling* assets, firms' assets and the crisis period have a significant negative effect on firm value.

Finally, Kang et al., (2014) examine whether related party transactions are used as a *tunneling* mechanism between firms belonging to large business groups in Korea (chaebol). Using 982-panel data by firms and years with publicly listed firms in Korea, they found that ownership control is positively related to the magnitude of related party transactions. The related party transactions will increase with the increase in voting rights, while the related party transactions will decrease with the increase in cash flow rights. Their findings also prove that ownership control is also associated with related party transactions among the 5 largest chaebol firms where the agency conflict between controlling and minority shareholders is more severe than in the 5 non-big chaebol firms. Meanwhile, their findings also show a significant positive relationship between ownership control and related party transactions for related party transactions, both operational and non-operational transactions. They also found that the 5 *non-top chaebols* only used non-operational related party transactions, while the 5 largest chaebol firms used related party transactions, both operational and non-operational transactions. They also found that Korean *chaebol* firms' related party transactions, on average, reduce the firm value, but this occurs only when differences in control rights and cash flow rights are high and specific for the top 5 *chaebol* firms. Overall, these results indicate that related party transactions occur when the agency conflict problem is already severe in the firms' internal and the transaction is used as a means of *tunneling,* thereby reducing the firms' value.

## 5. Conclusion

A related party transaction is a transaction made by the firms to affiliated parties and often performed by controlling shareholders over the firms. Empirically, these related party transactions are larger in quantity in firms where their controlling shareholders have a larger wedge between control rights and cash flow rights. On the other hand, the increase in cash flow rights of the controlling shareholder reduces the number of related party transactions. Related party transactions are categorized into two main motives for these transactions. Related party transactions can be performed with the motive of *tunneling* or extracting firms' resources for the benefit of the controlling shareholder. The transaction will certainly impact minority shareholders and creditors due to the inefficient allocation of resources and the economic loss of the firms.

Related party transactions can also be performed with a motive of the controlling shareholder's desire to help firms facing financial problems, better known as *propping.* Transactions with *propping* motives positively impact minority shareholders and creditors in firms receiving propping assistance. Although these related party transactions have a positive impact, they also allow controlling shareholders to *tunnel* in the future. In addition, *propping* always uses resources from other related firms, so it could be that *propping* in certain related firms is funded through *tunneling* from other related firms. In summary, related party transactions occur due to conflicts of interest between controlling and minority shareholders and creditors. Therefore, the regulator's response by paying special attention to the restrictions on these transactions and more credible reporting is needed to protect the rights of minority shareholders and creditors. Further, they also have to provide information as a basis for making investment decisions by minority shareholders and information for decision-making in monitoring or supervisory activities carried out by creditors.

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