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Valuation of firms that disclose related party transactions ☆,☆☆

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ABSTRACT

We examine the stock market's valuation of firms that disclose related party (RP) transactions compared to those that do not. We examine market values just prior to the Sarbanes-Oxley Act (SOX) ban on RP loans to evaluate the market's perception of firms with RP transactions prior to regulatory intervention. We also evaluate subsequent returns to assess the RP firms' overall risk return profile. We use the 2001 S&P 1500 to provide a large yet manageable hand-collected sample that predates SOX. Our market analysis suggests that RP firms have significantly lower valuations and marginally lower subsequent returns than non-RP firms. Market perceptions differ based on partitioning firms by RP transaction type and parties. The results are consistent with the market discounting firms that engage in simple RP transactions.

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1. Introduction

We examine the stock market's valuation of firms that disclose related party (RP) transactions. A number of firms that engaged in recent high profile frauds also disclosed RP transactions in their

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☆☆ Data availability: The data used in this study is available from public sources indicated in the paper, and from the authors by request.

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financial statements. The United States Congress responded to this apparent association by banning RP loans to officers and directors as part of the 2002 Sarbanes-Oxley Act (SOX). Our study examines the market valuations of firms that disclose RP transactions in 2001 prior to the fraud revelations and Congressional ban to obtain an unbiased assessment of RP transactions. We also examine market returns in 2002 to evaluate whether our valuation findings represent an underlying risk and return association.

Our pragmatic motivation to study RP firms stems from the Congressional ban on RP loans to officers and directors in section 402 the 2002 Sarbanes-Oxley Act (SOX).[1] Congress did not appear to rely on any systematic research in deciding to ban RP loans.[2] The ban's inclusion in SOX suggests it was aimed at the recent frauds that involve RP transactions. For example, both Tyco and WorldCom provided and disclosed loans to executives, and Adelphia disclosed guaranteed related party debt and executive loans. While our research cannot decide whether Congress acted properly in banning these transactions, we can provide systematic evidence on the markets' perception of RP transaction firms prior to the ban.

We add to theory by investigating RP transactions to evaluate whether market valuations are consistent with (1) RP transactions being relatively benign transactions where their disclosure has little or no association with firm valuation or returns, (2) management or insider opportunism that results in lower firm valuations, or (3) the RP transactions being value-enhancing. Our study fits into a broader literature that examines the implications of "self-dealing" on firms and securities markets and the role of disclosure in mitigating the potential negative effects of self-dealing (Djankov et al., 2008). RP transactions have the potential for insiders to extract firm wealth at the expense of other stakeholders. In contrast, RP transactions can be value-enhancing by creating strategic partnerships, enhancing risk sharing, and facilitating contracting.

The disclosure of RP transactions provides the market with the information necessary for investors to discipline opportunistic behavior. However, the ability to discipline behavior is not equivalent to the ability to prevent such behavior. Investors cannot directly prevent RP transactions. Investors are limited to voting with their feet by selling or refusing to buy the stock of RP firms, or ex post litigation against opportunistic insiders. Jensen and Meckling (1976) show an insider who owns less than 100% of the firm does not bear the full cost of his consumption of firm benefits. An insider can therefore engage in RP transactions with the firm that are more beneficial than costly to him, and investors who have taken price protection via lower demand for the stock have little reason to protest the transaction. As a result, equilibrium of RP transaction disclosure and lower firm valuation can exist.[3]

We review and classify RP disclosures from fiscal 2001 Form 10-Ks (annual reports) and definitive proxy filings for the 1194 firms included in the S&P 1500 that have sufficient data for our tests. We find 63% of the sample firms disclose RP transactions in their footnotes and/or proxy statements.

We find a negative association between RP firms and their valuations. The market values RP firms approximately 8% lower than non RP firms. This result suggests differential valuation of firms disclosing RP transactions that is both statistically and economically significant. We also find that the market values residual income less for RP firms than non-RP firms. The residual income finding suggests investors place less reliance on reported income, and/or discount the return to shareholders from future income. Our analysis of subsequent stock returns documents that RP firms experience marginally lower stock returns in 2002. The returns findings imply that investors are not compensated for the lower RP market valuations with higher subsequent returns.

We next consider whether all types of RP transactions have the same implications for valuation and returns. We classify the RP disclosures based on the nature of the transaction and the related party to the transaction (details of the classifications are provided in the Appendix). We group the detailed classifications into three broad categories – loans, other simple transactions and complex strategic

[1] Section 402 allows loans existing at the date of the act and loans that are essentially in the normal course of business and at normal terms to continue. This allows financial institutions to continue to provide normal consumer related loans at market rates to their officers and directors.

[2] Post Sarbanes-Oxley, the Securities and Exchange Commission's (SEC) examined enforcement actions from 1997 to 2002 and found that 23 of the 277 enforcement actions were related to the failure to properly disclose related party transactions (SEC, 2003).

[3] We acknowledge that if the valuation penalty became large enough other market related mechanisms such as take-overs, and buy-outs could be used to correct the opportunism.

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