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Related-party transactions and corporate governance: The evidence from the Taiwan stock market

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ABSTRACT

In this study we explore how corporate governance affects the level of related-party transactions (RPTs) and how it moderates the motives of using RPTs in Taiwan, an ownership-concentrated economy. The empirical results show that good corporate governance is effective in constraining RPTs with the negative relation being sustainable across different measures of RPTs (raw, residual and industry-adjusted RPTs) and across different types of RPTs (related sales, lending and guarantee, and related borrowings). The propping-up hypothesis indicates that the level of related sales is positively correlated with the condition that firms plan to issue seasoned equity next period and the condition of a decrease in the reported earnings. The internal capital market hypothesis indicates that the level of related lending and guarantee (related borrowing) is negatively (positively) correlated with the condition of an increase in capital expenditure and an increase in net working capital. The empirical results lend partial support to the two hypotheses. More importantly, we find that corporate governance moderates the relation between the motives and the level of RPTs.

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1. Introduction

Controlling owners can expropriate wealth from minority shareholders through various ways, such as self-dealing transactions, preferential loans, transfer assets, and acquiring additional shares at a preferential price (Johnson et al., 2000). However, most anecdotal evidence is indirect (e.g. Bertrand et al., 2002; La Porta et al., 2000, 2002; Claessens et al., 2002; Faccio et al., 2001), and the findings so far are mixed to

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vindicate that minority shareholdings lose value as a result of specific expropriation actions (e.g. Bae et al., 2002; Buysschaert et al., 2004).

Related-party transaction (RPT) has emerged as direct evidence of wealth exploitation (e.g. Cheung et al., 2006; Berkman et al., 2009). A recent forum launched by OECD specifically indicates that Asian economies should adopt a comprehensive approach to monitoring and curbing abusive related party transactions which represent the most pervasive challenge of corporate governance for Asian countries. Moreover, the case of Enron in which shareholders sustain burdensome losses resulted from RPTs (Thomas, 2002) further portrays the importance of this issue. Since then, it is not uncommon for disgruntled dissident shareholders to argue that the RPTs are unfair to outside shareholders (Battaglia, 2000). In the US case, the Securities and Exchange Commission (SEC) proposed amended disclosure rules as to mandate that either a firm's audit committee or another independent body of directors review and approve all RPTs.

RPT could be further decomposed into several sub-categories with one for each being explored separately. For example, Berkman et al. (2009) indicate that the issuance of loan guarantee is unambiguously a tunneling practice. Tunneling, as per Liu and Lu (2007) definition, is like a wealth expropriation from minority shareholders by controlling shareholders. In practice, it is more prominent in the cases when listed companies transfer profits out to other listed or unlisted related entities. Lo et al. (2010) focus on related-party sales to distort financial statements leading to greater information asymmetry and a general erosion of confidence in the firm.

In this study we firstly explore the relation between corporate governance and the level of RPTs. Corporate governance, as manifested in ownership and boardroom structure represents the governance style and has been proven to be effective in alleviating opportunistic behaviors of management, improving reporting quality, and increasing firm value.¹ It has been used to help explain different corporate policies.² We hypothesize a negative relation between corporate governance and the level of RPTs because good corporate governance mechanisms should enhance the fairness among the different stakeholders in the business (Collier and Esteban, 1999; Jensen, 2005; Matten and Crane, 2005). The argument is in line with Lo et al. (2010) who find that the quality of corporate governance is important in deterring the use of manipulated transfer prices in related-party sales transactions.

In this study we propose two alternative hypotheses and relate them to the use of RPTs. The first one is the propping-up hypothesis arguing that RPTs are used to prop up underperforming firms (Friedman et al., 2003). Jian and Wong (2010) show that Chinese listed firms use related sales to their controlling owners to prop up earnings. Bertrand et al. (2002) and Jian and Wong (2010) document that when there are incentives to meet earnings targets, related sales are used to dampen the effects of negative industry shocks on listed firms' earnings. We postulate two conditions that are related to the level of related sales for the purpose of propping up earnings: a plan to issue seasoned equity in the next period and a decrease in reported earnings. That is, the motive of propping earnings is strong when firms plan to issue seasoned equity in the next period and find that the reported earnings deteriorate. Therefore, the level of related sales is supposed to be positively correlated with condition of issuing equity shares and negatively correlated with the change in earnings per share. Moreover, if corporate governance plays a positive function, it should moderate the relation between the conditions and related sales. Specifically, the interaction between corporate governance and the condition of issuing seasoned equity is negatively correlated with related sales, and the interaction between corporate governance and the change in earnings per share is positively correlated with related sales.

The other hypothesis relating to RPTs is the internal capital market hypothesis which is derived from the transaction cost theory of Coase (1937) and Williamson (1964). This hypothesis implies that RPTs are used to replace external arm-length markets. There are benefits and costs associated with internal capital market. The benefits include better utilization and allocation of assets, better coordination among different activities, quicker feedback, deeper reciprocal knowledge, and a reduction of the hold-up problems. Nevertheless, there are costs associated with internal capital markets including the rent-seeking behavior

¹ See Chen et al. (2009), Bhagat and Bolton (2008) and Denis and McConnell (2003).

² For example, corporate restructuring (e.g., Denis et al., 1997; Ahn and Walker, 2007; Netter et al., 2009; Bauguess et al., 2009), dividend decisions (Brav et al., 2005), the pricing of executive stock options (Chidambaram and Prabhala, 2003), financial statements (Chung et al., 2002; Park and Shin, 2004), inter-group borrowings (Berkman et al., 2009), and corporate fraud (Chen et al., 2006).

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