Abstract

This study will examine the association between related party transactions (RPTs) and firm performance. Recent prescriptive rules in the U.S. (the Sarbanes-Oxley Act) have restricted company use of RPTs based on the assumption that they destroy shareholder value. However, there is limited research supporting this assumption with most prior research focusing on large U.S. companies. In contrast to the U.S., governance guidelines in Australia (e.g. the ASX ‘Principles of Good Corporate Governance’) are silent on company use of RPTs. Given this situation, this study will examine whether RPTs impact on firm performance in the Australian context. The focus is on small, new economy companies that were recently permitted to list under relaxed ASX listing rules. Because the nature of these firms suggests weaker governance relative to more established firms, it makes them ideal candidates to examine the impact of RPTs on firm performance. As this is the first study of its kind it is expected to make significant contributions to the governance literature, regulators, the accounting profession and corporate stakeholders.
1. Introduction and research question

Related party transactions (RPTs) have been linked to several of Australia’s largest corporate collapses (Institutional Analysis, 2002) and have recently become subject to scrutiny as part of approaches designed to improve governance standards. While accounting standards recognise that RPTs may have the potential to distort financial reports and should be properly disclosed, they have generally regarded these transactions as “a normal feature of commerce and business” (AASB 124, para. 5) and have not attempted to restrict or discourage them. However, stringent corporate governance measures introduced in the U.S. have now prohibited most related party loans between companies and their senior management.

Recent empirical studies in the U.S. have examined RPTs within large firms to determine the nature and consequences of these transactions. Gordon, et al. (2005) and Kohlbeck and Mayhew (2005) have found that RPTs are associated with weaker corporate governance characteristics and poor market performance. They conclude that RPTs are a conflict of interest between management and shareholders rather than efficient, value-adding transactions. While these studies have investigated RPTs within large U.S. firms, no known studies of RPTs have yet been conducted in Australia or have examined a sample of smaller-sized firms. In addition, the effect that RPTs have on long-run firm performance is not known.

The objective of this study is to investigate the associations between RPTs and performance within a sample of small, newly listed companies in Australia. Referred to as ‘commitments-test entities’ (CTEs), the firms examined are distinguished by the manner in which they have listed on the Australian Stock Exchange (ASX) and the additional reporting requirements they must adhere to. CTEs are generally ‘new economy’ firms with developing businesses (Australian Stock Exchange, 2002) and are not required to have a history of profitability. As a condition of their admission, the ASX requires them to provide the market with quarterly cash flow reports for at least the first eight quarters after listing. A unique feature of this quarterly report is the requirement to disclose related party payments and loans. Analysing these transactions within CTEs allows this study some important distinctions from prior research and takes advantage of the unique disclosures made within the quarterly cash flow report. There is also an opportunity to examine the effect that RPTs have on long-run performance.

2. Background and literature review

AASB 124 Related Party Disclosures defines RPTs as “a transfer of resources, services or obligations between related parties, regardless of whether a price is charged” (para. 9). Related parties include shareholders, directors, key management personnel, subsidiaries (and/or parent companies), and associates of these parties (AASB 124, para. 9). Gordon, et al. identify that RPTs are commonly “complex business transactions between a company and its managers, directors, or principal owners” (2005, p. 1).

Australian, U.S. and international accounting standards require disclosure of RPTs in periodic reporting.¹ These transactions are of primary concern because, by nature, they may not be conducted on an arm’s-length basis and on normal commercial terms (AASB 124, para. 6). While RPTs may have the potential to distort a firm’s reported financial performance and position (and hence require closer scrutiny), they are nevertheless regarded as “a normal feature of commerce and business” as firms conduct business through subsidiaries, joint ventures and associates (AASB 124, para. 5). However, in addition to the disclosure

¹ AASB 124 Related Party Disclosures is the Australian equivalent to the international accounting standard, IAS 25 Related Party Disclosures. The relevant U.S. accounting standard is FASB Statement No. 57 Related Party Disclosures.
requirements of accounting standards, RPTs have now become subject to corporate governance regulation.

In response to several large corporate collapses, the U.S. adopted prescriptive corporate governance rules with the introduction of the Sarbanes-Oxley Act of 2002. Despite being credited with quickly improving corporate governance standards in the U.S. (Chhaochharia & Grinstein, 2005), this rules-based approach has been heavily criticised for the haste in which it was introduced and the high compliance costs it has imposed upon companies, particularly those that are smaller or developing (see, for example, Chhaochharia & Grinstein, 2005; Linck, Netter, & Yang, 2006; Romano, 2004).

Australia has taken a different approach to improving governance, developing a ‘best practice’ framework rather than detailed rules (Hamilton, 2004, p. 4). The Australian Stock Exchange (ASX) introduced the ‘Principles of Good Corporate Governance’ in 2003, addressing issues such as board structure, financial reporting, ethics and remuneration policies. Although it is not mandatory for Australian listed entities to comply with these principles, they must provide reasons for any departure (ASX Listing Rule 4.10.3). The flexibility of this approach is favoured by market participants and supported by the OECD (Hamilton, 2004).

The corporate governance regimes in Australia and the U.S. differ on the subject of RPTs. The Sarbanes-Oxley legislation now prohibits most related party loans to executives and directors in the U.S., while in Australia there is no equivalent guidance. In fact, there is no reference to RPTs in the ASX Principles of Good Corporate Governance. The U.S. regulatory approach implies that RPTs (particularly those involving loans to management) are not in shareholders’ best interests and, therefore, should be prohibited.

Because RPTs are potentially not conducted on an arm’s length basis, managers may have the ability to act in an opportunistic way (to the detriment of shareholders). This is consistent with agency theory proposed by Jensen and Meckling (1976). The alternative view of RPTs is that they may in fact represent a form of efficient contracting, hence adding economic value. RPTs may take advantage of specialised skills or expertise and act as a bond between the related party and the company (Gordon & Henry, 2005).

Empirical studies in the U.S. generally support the contention that RPTs conflict with shareholders’ interests. Gordon, et al. (2005) analysed the RPTs of 112 public companies in the U.S. in 2000 and 2001 (prior to the introduction of Sarbanes-Oxley). They found that related party transactions are widespread, but are less common in firms with stronger corporate governance characteristics. They also identify a negative relationship between firms’ market performance and the number and magnitude of related party transactions. This relationship is particularly strong in the case of related party loans, lending support to the Sarbanes-Oxley prohibition. Overall, Gordon, et al. (2005) conclude that RPTs generally (and loans to executives in particular) represent a conflict of interest and are detrimental to shareholders’ interests.

In a concurrent study, Kohlbeck and Mayhew (2005) examined whether the RPTs of 1,261 US companies in the S&P 1500 Index are an agency cost or a method of efficient contracting. They also found that RPTs are associated with a lower return on assets and weaker corporate governance. Moreover, where cash-based remuneration of directors and executives is low (for example, where share options are issued in place of higher cash salaries) they found that related party loans are more frequent. Related party loans may therefore be used as a substitute form of compensation for less liquid remuneration (Kohlbeck & Mayhew, 2005).

2 See also ‘US companies rise to top of corporate governance table’, Financial Times, 7/9/04, page 23.
They show that RPTs “are more likely to occur when management has the ability and the incentives to engage in them” (p. 6) and hence impose agency costs on shareholders.

The limited prior research on related party transactions has focused on the impact of RPTs on large companies in the U.S. This study builds on that literature by analysing such transactions with respect to a subset of small, newly-listed companies in Australia. Referred to as ‘commitments-test entities’ (CTEs), these firms are distinguished from other ASX-listed companies by different admission rules under which they list, and additional special reporting requirements.

In 1999, the ASX relaxed its admission rules3 to allow entities holding more than fifty per cent of their tangible assets in cash to list, providing they make ‘commitments’ to eventually reduce this proportion to less than half. This concession “facilitated the admission of smaller entities with developing businesses based on new technology or other intellectual property assets” (Australian Stock Exchange, 2002, p. 2). The general profitability requirement which applies to other entities had prevented many of these firms from listing (Fargher & Woo, 2002). The ASX draws parallels between such new and emerging companies to mining exploration companies (Australian Stock Exchange, 2002), presumably because of higher risks and governance concerns associated with CTEs (Gallery, Gallery, & Sidhu, 2004). Unlike the U.S. and the U.K., Australia does not have a separate exchange for smaller, developing companies4 with the ASX not outwardly distinguishing CTEs from all other listed entities.

Klein and Mohanram (2005) show that firms entering the market via less stringent NASDAQ listing rules (particularly when a history of profitability is not required) are generally poor-performing and more risky. Parallels can be drawn between the changes to the NASDAQ listing rules in the U.S. in the late 1990s and amendments made to the ASX listing rules to admit CTEs. Both the NASDAQ and the ASX experienced a surge in new listings coinciding with the ‘dot-com boom’ and the changes made to their admission rules. A significant proportion of these companies would not have been permitted to list under the earlier, more conservative rules (Fargher & Woo, 2002; April Klein & Mohanram, 2005).

As a condition of their admission, CTEs are required to provide quarterly cash flow (QCF) reports to the ASX for at least the first eight quarters after listing (ASX Listing Rule 4.7B). This additional reporting requirement was introduced because established periodic reporting is considered to be insufficiently frequent to meet the market’s information needs (Australian Stock Exchange, 2002) and it is intended to mitigate the increased risks to investors exposed to these entities. Apart from mining exploration companies, CTEs are the only entities in Australia that must provide any form of quarterly reports as part of their routine periodic reporting regime (Gallery et al., 2004).

The format of QCF reports is prescribed by Appendix 4C of the ASX Listing Rules, and comprises a pro-forma cash flow statement with some limited ‘note’ disclosures. This report, which is not required to be audited or reviewed by the auditor, must be lodged within one month of the end of the relevant quarter. CTEs must continue to lodge QCF reports until the ASX determines that they have reached “sufficient maturity”, which is usually signalled by four consecutive quarters of positive cash flows from operations (Australian Stock Exchange, 2002). A unique feature of the QCF report is the requirement to disclose cash payments and loans to related parties.

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3 In particular, ASX Listing Rule 1.3.2(b).
4 For example, NASDAQ in the U.S. and AIM in the U.K. both cater for smaller listings than the New York Stock Exchange and the London Stock Exchange, respectively.
The ASX Listing Rules and Guidance Notes do not provide a rationale for requiring these unique disclosures, but it would seem that their purpose is to give an indication of the governance environment of the reporting entity. Given that CTEs hold a high proportion of cash as assets, investors would be interested in information disclosing how that cash is applied. RPTs may be of particular concern if they are perceived as inappropriate or unusual.

3. Methods of data collection and analysis

On the basis of prior literature, it is hypothesised that there will be a negative association between the magnitude of related party transactions and firm performance for CTE firms. Figure 1, below, provides an overview of the model that will be tested.

This study will examine RPT data from both the quarterly cash flow and annual reports of CTEs. The quarterly cash flow data will be based on the Gallery et al. (2004) database. This contains the population of quarterly cash flow reports issued by firms subject to 4C Reporting since Listing Rule 4.7B was introduced on 31 March 2000. In total, Gallery et al. (2004) identify 331 companies that have lodged Appendix 4C quarterly cash flow reports between March 2000 and December 2003. That database has been extended to December 2005 and this study will draw on that extended dataset. RPT disclosures from the annual reports of these companies will complement the quarterly data. The annual reports cover the period from 2000 to 2005. Consistent with Gordon et al. (2005), transactions with wholly-owned parents/subsidiaries and ordinary fees and salaries paid to directors or executives will be disregarded.

Governance characteristics will be sourced from each firm’s annual financial report, which can be obtained through Aspect Huntley’s FinAnalysis database. Market data (including market capitalisation and market capitalisation rank) will be drawn from the Share Price and Price Relatives (SPPR) database maintained by the Australian Business School’s Centre for Research in Finance.

![Figure 1: Research model](image-url)
To test the hypothesised relationship, a two-stage regression model will be employed. Following Gordon et al. (2005) RPTs will first be regressed against the corporate governance factors (Equation 1). The residual from this regression will then be used to test for the independent effect of RPTs on firm performance (Equation 2).

Equation (1) can be stated as:

\[ RPT = \alpha_0 + \beta_1 \text{INDIR} + \beta_2 \text{BSIZE} + \beta_3 \text{AUD} + \beta_4 \text{AUDC} + \beta_5 \text{CHAIR} + \beta_6 \text{LEV} + \text{RESIDUAL} \]  

where:

- **RPT**: the dollar value of related party transactions obtained from the quarterly cash flow report and annual report deflated by average total assets.
- **INDIR**: the proportion of independent directors on the board. Independent boards have been found to be more effective monitors of the financial reporting process, hence increasing the credibility of published results (April Klein, 2002; Peasnell, Pope, & Young, 2005; Rosenstein & Wyatt, 1990).
- **BSIZE**: the number of directors on the board. Yermack (1996) finds evidence of an inverse relationship between board size and firm value, suggesting that smaller boards are more effective.
- **AUD**: coded one (1) for firms engaging a Big-4 auditor and zero (0) otherwise. DeAngelo (1981) argues that larger audit firms are responsible for better quality audits. Audits by larger firms have been found to exhibit a higher earnings response coefficient, suggesting a higher level of credibility (Teoh & Wong, 1993).
- **AUDC**: coded one (1) for firms with an audit committee and zero (0) otherwise. The earnings management literature suggests that the absence of an audit committee is associated with more opportunistic behaviour (Dechow, Sloan, & Sweeney, 1996); however, the overall effectiveness of the committee (in preventing earnings manipulation) is a function of its independence and meeting frequency (Davidson, Goodwin-Stewart, & Kent, 2005; Xie, Davidson, & DaDalt, 2003). Assuming that audit committees are effective (on average), it is expected that the existence of an audit committee will provide a higher level of monitoring.
- **CHAIR**: coded one (1) where the chairman is a non-executive director and zero (0) otherwise. Prior studies have shown that when the roles of chairman and chief executive are segregated, internal control is stronger and the board performs its key functions (such as evaluating the chief executive’s performance) more effectively (Goyal & Park, 2002; Jensen, 1993).
- **LEV**: a ratio of total liabilities to total assets. Leverage proxies for external monitoring by creditors, which is seen as limiting the agency costs of free cash flows (Jensen, 1986, 1993).

Equation (2) uses the residual from Equation (1) to test for the association between RPTs and firm performance. It can be stated as:

\[ \text{PERF}^* = \alpha_0 + \phi_1 \text{RESIDUAL} + \lambda_1 \text{MCAP} + \lambda_2 \text{RISK} + \lambda_3 \text{AGE} + \lambda_4 \text{FINSLACK} + \lambda_4 \text{DIRFEES} + \lambda_5 \text{CEOCOMP} + \sum_{i=0}^{\lambda_6} \lambda_7 \text{IND} + \varepsilon \]  

where:

- **PERF***: alternative measures of firm performance:
PERF1: free cash flows, defined as the excess of all cash inflows for the quarter over cash outflows, available on a quarterly basis from the Appendix 4C report.

PERF2: an accounting measure of performance, such as net profit/profit margin.

PERF3: industry or market-adjusted returns. A small-firm index may also be an appropriate deflator.

PERF4: a dummy variable for survivorship, coded one (1) where CTEs have been delisted and zero (0) otherwise.

MCAP: a control for firm size, measured as the natural logarithm of market capitalisation on the last trading day of the relevant quarter.

RISK: risk, measured by beta or a market-to-book ratio.

AGE: firm age, measured as the number of quarters since initial listing as a CTE.

FINSLACK: the sum of ending cash balance and unused financing facilities for each quarter, deflated by total assets.

DIRFEES: a logarithm of directors’ fees, used as a measure of board incentive alignment following Gordon et al. (2005). Kohlbeck and Mayhew (2005) suggest that RPTs may act as a substitute for more usual forms of remuneration.

CEOCOMP: a logarithm of the chief executive or managing director’s total remuneration package, again following Gordon et al. (2005). RPTs may also act as a substitute form of remuneration for the CEO.

IND: a control for industry-sector based on the nine Global Industry Classification Standard (GICS) codes.

A time-series approach will be taken with the opportunity to examine longer-term performance over a period of two to three years after the instance of RPTs (see Barber & Lyon, 1997; Gompers, Ishii, & Metrick, 2003).

4. Expected contribution

This study will make important contributions to the existing literature by providing an understanding of related party transactions in the context of small, new economy firms and long-run performance. It will also provide the first evidence of the effect of related party transactions on Australian firms which is interesting in light of the regulatory differences between Australia and the U.S. This study will also offer further insights into the effect of related party transactions on a firm’s governance environment and an indication of the extent to which related party transactions might be acceptable to shareholders. The results of the study will have important implications for the corporate governance regulatory framework in Australia, the ASX and other regulators, the accounting profession and corporate stakeholders.
References


