

# **The impact of related party transactions on firm value: Evidence from a developing country**

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## **Abstract**

The purpose of this study is to address the impact of related party transactions (RPTs) on firm value. We bring evidence from a usually ignored empirical setting: an African emerging market. In particular, we focus on companies listed on the Egyptian stock market using a sample of EGX 30 from 2012 to 2017. Data are collected manually from the company's annual reports. Unlike the literature, we find no significant relationship between RPTs and market value. The reported different findings of this study assure the intermediary role of the context and the local culture in the relationship between RPTs and firm value, in contrast to the negative view that is mostly reported in the literature. This research provides insights for policy makers and other interested parties concerning the perception and implications of RPTs in Egypt.

Keywords: Related Party Transactions, Firm Value, Egyptian Context, Emerging Markets.

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## 1. Introduction

Recent scandals in the United States, such as Adelphia and the Riga family's corporate group, and Hollinger and Conrad Black's corporate group, have brought related party transactions under the spotlight. The majority of the literature addresses the value relevance of disclosing RPTs (e.g. Chen et al., 2009; Ge et al., 2010; Kohlbeck and Mayhew, 2010). For example, Kohlbeck and Mayhew (2010) suggest that firms that disclose RPTs have significantly lower valuations and marginally lower subsequent returns than firms that do not make such disclosure. On the other hand, some studies reported that RPTs can positively affect corporate performance (e.g. Djankov et al., 2008; Peng et al., 2011).

We observe that the reported results in the literature are not always clear or consistent (Cheung et al., 2009; Pizzo, 2013): some studies reported a positive relationship between RPTs and firm value (e.g. Djankov et al. 2008); other studies reported a negative relationship (e.g. Gordon et al. 2006); and other studies reported that this relationship is conditioned upon some factors such as corporate governance (e.g. Chen et al., 2017; Yeh et al., 2012). For example, Chen et al., (2018) indicated that better corporate governance might have an effect of reducing tunneling through RPTs. This inconsistency regarding the influence of RPTs on firm value indicates to the need for more evidence.

Additionally, we believe that the relationship between RPTs and firm value is context-dependent; rather than being universal. However, it is observed that the vast majority of previous work focuses on U.S. and European capital markets (e.g. Aktas et al. 2008; Biesta et al. 2003; Del Brio et al. 2002; Fidrmuc et al. 2006; Gregory et al. 1997). This focus on developed and stabilized context decreases the possibility to perceive the impact of different contexts' specificities on the relationship between RPTs and corporate performance. For example, investigating high-technology firms in Taiwan and China from 1998 – 2008, Huang and Liu (2010) find that the accounts (notes) receivables and accounts (notes) payables from related-parties of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance. However, the sales or purchases of goods from related party transactions of high-technology firms in China have a significant (negative) relationship with performance. This view invites us to address the impact of RPTs on firm value in different contexts, especially in emerging and African markets, which are rarely investigated in the literature.

This study brings further evidence on the relationship between RPTs and firm value from a different context – that is, it contributes to the literature by bringing evidence from an emerging context: the Egyptian stock market. In particular, our study uses a sample of firms listed in the EGX 30 from 2012-2017<sup>1</sup>. In Egypt, as Eldomiaty (2007) argued, the capital market is less

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<sup>1</sup> The EGX 30 Index is a free-float capitalization weighted index of the 30 most highly capitalized and liquid stocks traded on the Egyptian Exchange. EGX 30 constituents are reviewed and changed twice a year (end of January and end of July). The index was developed with a base level of 1000 as of January 1st 1998 and previously named CASE 30 Index.

efficient and suffers from higher level of information asymmetry than capital markets in developed countries. This context is reported to cause financing decisions to be incomplete and subject to a considerable degree of irregularity (Ebaid, 2009). Considering the unique specificities of the context, it is necessary to examine the RPTs' impact on corporate performance in Egypt as an example of emerging economies.

Our results support studies in the literature that find no significant relationship between RPTs and corporate value (e.g. Kuan et al., 2010; Pozzoli and Venuti, 2014). This group of studies, so does ours, conclude that related party transactions and companies' financial performance results are not necessarily correlated –that is, there is no evidence of a cause-effect relation between them. According to this perspective, the existence of such transactions does not necessarily mean the existence of practices that undermine firms' value such as earnings management practices and achieving personal benefits to management on the account of business owners (see Gordon and Henery, 2005; Jian and Wong, 2004).

The paper is structured as follows. Section 2 provides a background of the study. Section 3 presents an overview of the literature and theoretical perspectives used to explain the present research issue. Section 4 clarifies the research model and the sample used to conduct this research. Section 5 presents the findings of the study. Finally, section 6 outlines the concluding remarks of the study.

## **2. Background**

Egypt's stock exchange has two locations: Cairo and Alexandria. The Alexandria Stock Exchange was officially established in 1888, and then Cairo Stock Exchange was established in 1903. However, they were not very active until 1940s when the Egyptian Stock Exchange ranked fifth in the world. Afterwards, the central planning and socialist policies adopted in Egypt in the mid-1950s led to a reduction in their activity, which continued until late 1980s (Rizk et al., 2008).

In the beginnings of the 1990s, the Egyptian government started a wide economic reform program, moving towards a free-market economy. Here, the processes of deregulation and privatization have stimulated more activity again in the stock market. The Capital Market Authority (CMA), which was founded in 1979, has played a part in facilitating this process through providing the necessary guidelines and regulations. As a result of these efforts, by the end of mid-2002, 1,136 companies were listed on the stock exchange compared to 656 companies listed in 1992 (Rizk et al., 2008). Then, market capitalization grew significantly from L.E. 5 billion in 1990 to L.E. 815 billion in 2008 (CMA, 2008).

The government of Egypt has recently passed legislation to impose international standard requirements on financial reports for all publicly-traded companies on the stock exchange. In particular, the Minister of Investment has issued the Ministerial Decree No. 243 in 2006 to incorporate the new Egyptian Accounting Standards – prepared according to international

accounting standards with some minor exceptions – replacing the ones issued by ministerial decrees numbers 503/1997 and 345/2002. The CMA is working to improve compliance with accounting standards. It reviews financial statements of listed companies to ensure timely and full compliance with the Egyptian Accounting and Auditing Standards.

In Egypt, the primary financial-disclosure vehicle for listed companies is the annual report. According to the Capital Market Law No. 95 of the year 1992, all the companies listed on the Egyptian Stock Exchange must comply with the disclosure rules required by the law. In particular, they are required to provide copies of their annual and semi-annual financial statements to both CMA and the Egyptian Stock Exchange and to publish a summary of them in two daily newspapers, at least one of which must be in Arabic (Hassan et al., 2009). They are required to comply with Egyptian Accounting Standards, and in the absence of specific Egyptian standard regarding an accounting practice, international accounting standards must be applied (Hassan et al., 2009). Mandatory financial disclosure includes the balance sheet, the income statement, the cash flow statement, the statement of changes in equity, the notes to the accounts, the board of directors' report, and the external auditor's report. RPTs and their effects, which are regulated by the Egyptian accounting standard no.15, are among the voluntary information to be disclosed (Dahawy and Conover, 2007).

However, it is worth indicating that, although in theory all listed companies are required to disclose information according to Egyptian and international accounting standards, prior studies on the financial-reporting practices of Egyptian listed companies have shown that noncompliance with disclosure requirements is the norm (see e.g. Abd-Elsalam, 1999; Dahawy et al., 2002; Fawzy, 2003; ROSC, 2002). This noncompliance was partially explained through the deep-rooted tendency towards secrecy in the Egyptian culture. Furthermore, as ROSC (2002) suggests, the lack of an effective enforcement policy for noncompliant companies has contributed to the low levels of compliance with mandatory disclosure among listed companies in Egypt.

This unique context has influences on RPTs' disclosures. For example, as Dahawy et al. (2002) report, the Egyptian business environment does not consider insider trading to be a problematic issue, as corruption and insider trading transactions continue to be the norm, they argue. For example, Harik (1997) observed that many local people accept bribery as a way of doing business. Further, Dahawy and Conover (2007) reported that close family relationships and insider trading in the Egyptian business environment are seen as a source of stability rather than as representing threat to the economy. Here, exchange of information among related parties does not appear to the government to be an issue which should be regulated (Dahawy, 2007). Thus, it is interesting to address impact of RPTs on corporate performance in this particular kind of context.

### **3. Related party transactions: Literature review and hypothesis development**

A related party is a person or entity that is related to the reporting entity. For example, a related party can be a person who has control or joint control over the reporting entity; or a member of the key management personnel of the reporting entity or of a parent of the reporting entity. The related party relationship can also arise if: one entity and the reporting entity are members of the same group; both entities are joint ventures of the same third party; one entity is an associate or joint venture of the other entity; or one entity is a joint venture of a third entity and the other entity is an associate of the third entity (IAS 24). A related party transaction can be defined as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged (IAS 24). Related-party transactions include, for example, raising capital, acquiring production materials, selling firm outputs, hiring workers, leasing assets, purchasing and divesting assets and signing franchising contracts (Huang and Liu, 2010).

In this regard, Gordon and Henry (2005) identify several major types of RPTs, such as direct transactions with employees or with board members, contract services or legal services acquired from management, sales to (purchases from) related parties and loans to (from) related parties. Further, Cheung et al., (2006) distinguished three categories of RPTs: transactions that – a priori – result in the expropriation of the firm’s minority shareholders (acquisition/sale of assets, commercial relations, etc.); transactions that may be to the advantage of the minority shareholders of the quoted company (cashing of liquid assets and relations with subsidiaries); and transactions that are carried out for strategic reasons and which therefore have no purpose of expropriation (takeover bids and alliances with equity investment, acquisitions and sales of shareholdings in shared subsidiaries).

RPTs are sometimes referred to as insider trading. This is when corporate insiders, like managers or members of the supervisory board, buy or sell stocks of their own company (Wang, 2010). In this regard, Jian and Wong (2004), for example, reported that RPTs of companies in Chinese group businesses are directed to their largest stockholders and these companies offer more trade credits to their related parties. Likewise, Kohlbeck and Mayhew (2004) show that companies in S&P 1500 provide more loans to their directors, officers, major stockholders and affiliates.

Thus, RPTs emerge when the company does business with a related or affiliated company. In this case, one company is in a position to influence financial decisions through its control or power over the other party. This suggests that RPTs can have influences on corporate value or performance. For example, a holding company might ask an affiliated company to decrease its research and development activity, or to end its relationship with another company. This issue is discussed in detail in Section 3.3.

### **3.1 The impact of RPTs in emerging markets**

An important portion of the literature that is concerned with the impact of RPTs is conducted in advanced contexts such as US and Europe. For example, Gordon et al. (2006) examined the relationship between RPTs and the value of companies quoted in the USA over the period 2000-2001. Kohlbeck and Mayhew (2010) also investigated the value relevance of RPTs disclosure in the USA stock market. Nekhili and Cherif (2011) investigated the factors that influence RPTs in companies listed in the Paris Stock Exchange. Pozzoli and Venuti (2014) investigate the relationship between RPTs and financial performance of Italian listed companies.

A significant portion of literature has also focused on the Asian context, specially the Chinese one (e.g. Ge et al., 2010; Huang and Liu, 2010; Jian and Wong, 2004; Wang and Yuan, 2012; Xiao and Zhao, 2012). Other scholars have also addressed the valuation of firms that disclose RPTs in related contexts such as Hong Kong and Singapore (Cheung et al., 2006; Chen et al., 2018), Taiwan (Huang and Liu, 2010; Lin et al., 2010), Korea (Kang et al., 2014) and Malaysia (Munir and Gul, 2010).

However, as indicated earlier, we believe that value relevance of RPTs is context-dependent; rather than being universal. This view is supported by some studies in the literature. For example, investigating high-technology firms in Taiwan and China from 1998 – 2008, Huang and Liu (2010) find that the account (notes) receivables and account (notes) payables from related-party transactions of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance. On the other hand, the sales or purchases of goods from related party transactions of high-technology firms in China have a significant (negative) relationship with performance. Additionally, indicating to the role of the context in mediating the relationship between RPTs and firm value, Munir and Gul (2010) argue that RPTs are likely to have negative effects on firm performance in Malaysia because of the weak investor protection laws and the lack of shareholder activism in this country (See Ball, Robin and Wu, 2003; LaPorta, Lopez-de-Silanes, Shleifer and Vishny, 2000; Leuz, Nanda and Wysocky, 2003). This view explains why the reported results in the literature are not always clear or consistent (Cheung et al., 2009; Pizzo, 2014).

This, in turn, invites us to investigate the impact of RPTs on firm value in different settings. We believe that emerging economies worth more focus. In this regard, Khanna and Palepu (2000) suggest that, in emerging countries with weak institutional support to businesses, transactions within business groups could assist the individual firms in the groups to operate more efficiently than standalone firms. For example, a firm could obtain financial support from other firms in the same group when it is unable to obtain them from the external capital market. Khanna and Palepu (2000) argue that the difficulties to get access to external capital market in less-developed countries by some firms could be due to the problem of information asymmetry which would result in the market being unable to accurately evaluate the firm. Therefore,

related party transactions (including related party loans) between firms in the group could minimize this problem. Consistent with this idea, Gopalan et al., (2007) document that loans between firms in the same group are important means of transferring cash across group firms and are typically used to financially support the weaker firms (see also Shin and Park, 1999 for evidence from Korea). Other studies have reported contradictory evidence from emergent markets. For example, Dahya et al. (2008) examined a sample of companies from countries where investor protection is low. They found that, in general, the companies that do not use RPTs have a higher value than those having recourse to such transactions: market reaction studies shows firms that use RPTs are associated with lower market values. These contradictory results exemplify how the economic value of RPTs can differ in different contexts – i.e. it is context-dependent.

This, in turn, directs our attention to the importance of investigating RPTs in less-developed or emerging settings. As above, some studies have taken some steps in this regard. But we believe that more evidence is needed from different contexts. Unlike the highly investigated Western and Asian contexts in the literature, this study brings further evidence from a different and rarely investigated context: an African context –the Egyptian stock market. This is necessary to understand how the culture of special contexts like this can mediate the influence of RPTs on organizational performance.

### **3.2 The impact of RPTs from a theoretical perspective**

RPTs have mainly been studied in the literature according to two different theories: conflict of interests and efficient transaction perspectives. First, according to the conflict of interests theory, RPTs are noted to imply moral hazard and that they are carried out in the interest of directors in order to expropriate wealth from shareholders. For example, according to this view, RPTs imply the misuse of a company's resources and the misrepresentation of its private information.

According to this perspective, the economic impact of RPTs on corporate performance is mainly explained through agency theory and the concept of tunneling. Here, RPTs are seen to arise from the agency conflicts between controlling shareholders and minority shareholders. This conflict is more apparent in emergent markets where legal protection of minority shareholders is weak. Here, controlling shareholders are noted to extract private benefits from minority shareholders through “tunneling”<sup>2</sup> (e.g. Claessens et al. 2006; Glaeser et al. 2001; Jian and Wong, 2004; Johnson et al. 2000; La Porta et al. 2000). For example, Kang et al., (2014) suggest that RPTs occur when the agency problem is severe and they are used as a means of tunneling, thus

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<sup>2</sup> Johnson et al., (2000) introduced the concept of tunneling as the transfer of assets and profits out of firms for the benefits of those who control them.

destroying firm value. This is because, especially in an environment of concentrated ownership, the conflict of interest between minority shareholders and controlling shareholders creates a serious agency problem (e.g., La Porta et al., 1999; Claessens et al., 2000; Lemmon and Lins, 2003).

Further, according to this perspective, related party transactions are noted to compromise management's agency and responsibility to shareholders or a board of director's monitoring function (See e.g. Berle and Means, 1932; Jensen and Meckling, 1976). For example, Jensen and Meckling (1976, 313) portray the agency conflict between a manager and outside shareholders as the manager's tendency to appropriate the firm's resources for personal consumption, like perquisites.

As such, from this perspective, related party transactions indicate the potential for the expropriation of the companies' resources (Gordon et al., 2004). It is suggested here that managers will over consume perquisites, for example by transferring out some benefits to themselves, and this over-consumption damages the firm's stakeholders (Fama and Jensen, 1983; Jensen and Meckling, 1976). In other words, managers are noted to conduct related party transactions with the intentions of transfer the wealth or profits of the firms to them. Alternatively, these transactions could be used to expropriate minority shareholders of the firms because with the effect of these transactions, the minority shareholders are left with a smaller portion of wealth for them to claim.

Here, RPTs result in higher agency costs due to the alignment of decision-making rights and monitoring rights (Huang and Liu, 2010). Thus, following this perspective, a significant portion of the literature documents a negative association between the control–ownership wedge and firm value suggesting that the self-serving behavior of controlling shareholders undermines corporate performance and thus destroys firm value (e.g., Claessens et al., 2000, 2002; Joh, 2003; Lins, 2003; Lemmon and Lins, 2003).

On the other hand, as regards the efficient transaction perspective, RPTs are noted to improve economic efficiency by reducing transaction costs (e.g., Ryngaert and Thamas, 2007). Studies that support this perspective explain how RPTs can efficiently fulfill the underlying economic needs of the company (Gordon et al., 2004). This view considers RPTs as sound business exchanges fulfilling economic needs of the company (e.g. Djankov et al. 2008; Peng et al., 2011). Unlike scholars that support the conflict of interests perspective, scholars in this camp see that RPTs do not harm the interests of shareholders and emerge as efficient contracting arrangements where there is incomplete information. Moreover, they report that some benefits will emerge out of engaging in RPTs such as: contracting party representatives appointed as board members to facilitate the achievement of better coordination of the different activities; getting quicker feedback or more insights; obtaining deeper reciprocal knowledge



as well as greater familiarity, which can create more convenient terms and conditions for both parties and justify transactions that are not feasible at arm's length; and mitigating hold-up problems (Huang and Liu, 2010).

### **3.3 The implications of RPTs for corporate performance**

RPTs can have a significant impact over business transactions or business performance. Several studies have investigated the influence of RPTs on corporate performance or economic value. However, the findings regarding the real influence of RPTs on corporate performance are so far mix and sometimes contradictory. That is, extant academic studies provide inconsistent evidence regarding the effect of RPTs on firm value.

Noticeably, a large portion of the studies notes that RPTs imply serious or negative connotations. This view is, in part, related to the exclusive information that insiders or related parties can have. Previous empirical studies on insider trading/RPTs highlight the ability of insiders to earn significant abnormal returns (see e.g., Lakonishok and Lee, 2001; Aktas et al. 2008). Thus, RPTs can increase the risks that those parties obtain exclusive information to make abnormal returns (see also Lei and Wang, 2011). In this regard, Elhelaly (2014) and Geng (2014) indicated to the existence of a significant relationship between RPTs and earnings management practices perpetrated by majority shareholders. Gordon and Henry (2004) show that abnormal accruals are positively associated with RPTs. They imply that RPTs may reduce earnings quality. In this sense, knowing and addressing RPTs can help us evaluate a company's performance, the risks it faces, and the opportunities it can get.

Here, RPTs are often viewed as being inconsistent with shareholder wealth maximization. For example, Gordon et al., (2004) find that industry-adjusted returns are negatively associated with RPTs. In particular, they find a negative relationship between industry-adjusted returns and the number and dollar amount of loans to executives and non-executive directors, and a similar relationship between other types of RPTs with non-executive directors. Gordon et al. (2006) examined the relationship between RPTs and the value of companies quoted in the USA over the period 2000-2001. They find that abnormal stock market yields are negatively related to RPTs. They stated that RPTs can imply moral hazards, and can be carried out in the interest of directors in order to expropriate wealth from shareholders. Relatedly, Kahle and Shastri (2004) documented that loans to executives are made at lower than market rates, and that loans made to managers related to stock and option transactions are relatively inefficient in increasing managers' stock ownership. Further, while examining a sample of companies from countries where investor protection is low, Dahya et al. (2008) found that, in general, the companies that do not use RPTs have a higher value than those companies that engage in this kind of transactions: they show firms that use RPTs are associated with lower market values. Chen et al., (2009) show that Chinese listed companies controlled by a related party engage in a higher the level of related party transactions, and this has a negative influence on the operational performance of the listed company. Lo et al. (2010) reported that related party sales distort

financial statements leading to greater information asymmetry and a general erosion of confidence in the firm. Similarly, Nekhili and Sherif (2011) show that the frequency of RPTs can be damaging to companies and can destroy their market value. Wang and Yuan (2012) show an adverse impact of related party sales of goods and services on the usefulness of accounting earnings to investors and on the quality of earnings forecasts by financial analysts (See also Aharony et al., 2010; Cheung et al., 2006; Kohlbeck and Mayhew, 2010; Xiao and Zhao, 2012).

As outlined earlier, this reported negative impact of RPTs on a firm's value or its financial performance is based on the idea that they can be used by management to achieve personal benefits away from the shareholders' interests. Apart from their declared motives, RPTs are noted here to be exploited to the enrichment of one party at the expense of other parties that are not involved in the transaction. In other words, these transactions will lead to the expropriation of minority shareholders, to the benefit of controlling shareholders, directors or administrators. These latter dominating groups can make profits by selling to the firm (or buying from it), assets, goods or services, at prices higher (lower) than the market price (Cheng and Chen, 2006). They can also obtain loans on favorable terms (La Porta et al., 2003), use the firm's assets as security for their personal loans, or even dilute the interest of minority shareholders by acquiring additional shares at preferential prices (Johnson et al., 2000). In a recent study, Bona-Sanchez et al., (2017) revealed that financial, operating and investment dimensions of RPTs negatively affect firm value due to the presence of an expropriation effect whereby RPTs are driven by insiders' opportunism.

As explained in section 3.2, these serious effects of RPTs on firm value arise from the conflicts of interests between controlling shareholders and minority shareholders and that these transactions are carried out in the interest of controlling shareholders to expropriate wealth from minority shareholders (Shin and Park, 1999; Chang and Hong, 2000; Johnson et al., 2000). For example, Kohlbeck and Mayhew (2004) indicated to the tendency of the owners to move profits from a firm where they have low cash flow rights to a firm where they have high cash flow rights (Bertrand et al., 2002) so that the controlling owner would have higher claim on the profits. Cheung et al. (2009) indicate that companies acquire assets from related parties at a higher price and also sell at a lower price in comparison to similar arms' length transactions. Expropriation of resources could be realized through channels such as unreliable related party sales (Wang and Yan, 2012), abnormal accruals associated with certain types of transactions such as those involving fixed-rate financing from related parties (Gordon and Henery, 2005), extension of loan guarantees to related parties (Berkman et al., 2009), loans which have below-market interest rates (Shastri and Khale, 2004) private securities offerings by industrial groups (Baek et al., 2006), excessive executive compensation (Djankov et al., 2008) and generous credits provided when the company has exceeding cash (Jian and Wong, 2004).

On the other hand, other scholars have reported a positive influence of RPTs on corporate financial performance: they note that RPTs can enhance corporate value. The positive influence of RPTs can emerge through using the company's available resource in a way that maximizes owners' interests. In this regard, Djankov et al. (2008) note that no country completely bans RPTs, supporting the notion those RPTs, can be value enhancing. Peng et al. (2011) show how markets react favorably to the announcement of RPTs.

Scholars representing this camp argue that RPTs can promote and preserve the company's assets. And that a company can obtain better or more effective services through RPTs than the services they get through hiring an outsider. This is because, they argue, insiders possess an extensive knowledge of the firm. And this, in turn, would reduce information asymmetries and enhance contracting (Gordon et al., 2004). In this regard, Lei and Song (2011) showed that the size of internal transactions depends on the information available to internal parties before the company makes the necessary disclosures. And that internal parties make intensive purchases when the information related to revenues are positive and on the other hand, they make intensive selling when these information are negative. That is, these transactions are motivated by the information known exclusively to its parties; an issue that results in abnormal returns to them. Thus, here, transactions between related parties and firms are noted to involve less information asymmetry between the two parties, than is typically the case when the transaction occurs between the firm and a third-party. The resultant elimination of asymmetry of information available to management and stockholders would result in positive influences of RPTs on organizational performance (Cai et al., 2015; Cormier et al., 2009; Elbadry et al., 2015).

As outlined in Section 2.2, according to the efficient transaction perspective (Gordon et al., 2004), RPTs are considered sound business exchanges, resulting in lower dealer cost and economically fulfilling the needs of the firm. The proponents of this perspective see that RPTs can be used as efficient contracting mechanisms under incomplete information achieving shareholder value maximization. And this, in turn, is argued to reduce transaction costs and thereby achieve economies of scale (Khanna and Palepu, 1997; Stein, 1997; Williamson, 1975). In this context, Shastri and Kahle (2004) find that executives benefit from related party loans, which, on average, have below-market interest rates. Chen et al., (2012) point out that RPTs are beneficial to mutual monitoring. And that the monitoring implied in RPTs suggests a difference in the agency cost.

Finally, other scholars reported that the influence of RPTs on corporate value is conditioned upon some factors with special reference to corporate governance. For example, Ullah and Shah (2015) see that the independence of the board of directors has a positive influence on RPTs. On the other hand, ownership interests of the executives have negative influence on RPTs. Others reported that the negative influence of RPTs on corporate performance is mitigated with the existence of effective corporate governance mechanisms (Aswadi et al., 2011; Chien and Hsu,

2010; Rahimian and Mohammadi, 2012) –that is, the existence of governance mechanisms is noted to rationalize the motives behind RPTs (Yeh et al., 2012). For example, investigating companies listed on the Paris Stock Exchange during the period 2002-2005, Nekhili and Sherif (2011) find that RPTs are mainly influenced by the voting rights held by the main shareholder, the size of the board of directors, the degree of independence enjoyed by the audit committee and the board of directors, the choice of external auditor, the debt ratio and the fact of being listed in the USA. They also find that the transactions carried out directly with the main shareholders, directors and/or managers have a negative influence on firm value. Investigating Korean chaebol (conglomerates) firms, Kang et al., (2014) find that RPTs to reduce firm value, but this value destruction is observed only when the control–ownership wedge is high and is more pronounced with the top 5 firms.

As above, the literature is unclear or mixed as to whether RPTs are value destroying or value-creating (Cheung et al., 2009; Berkman et al., 2009). In this study we seek to prove if related-party transactions have a significant relationship with firm value through bringing evidence from an emergent market –the Egyptian stock market. This is done through testing the following hypothesis:

H1: RPTs are not associated with the market’s valuation of firms.

## 4. Research design and sample selection

### 4.1 Sample selection

Our initial sample consists of the Egyptian listed firms in the EGX 30 from 2012 to 2017. Therefore, the initial sample includes 180 observations: 12 observations, which were related to financial institutions, were excluded. The final number of observations, after excluding 13 missing observations, is 152 (Table 1).

**Table 1: Sample Size**

|                             | Number of Firm Year Observations |
|-----------------------------|----------------------------------|
| Initial Sample              | 180                              |
| Less Financial firms        | 12                               |
| Less Missing observations   | 16                               |
| Final number of observation | 152                              |

### 4.2 Research model and variables measurement

The following model is used to test the research hypothesis.

$$\text{LOGMV}_{it} = \alpha + \beta_{it} \text{RPT} + \beta_{it} \text{LOGTA} + \beta_{it} \text{CAXTA} + \beta_{it} \text{BV} + \beta_{it} \text{LEV} + \beta_{it} \text{ROA} + \text{Industry FE} + \text{Year FE}$$

(Equation)

The above model is designed to test the valuation of firms that make related party transactions disclosure. LOGMV is the logarithm of market value of common equity. Consistent with Kohlbeck and Mayhew (2010), RPTs is defined here as a dummy variable coded as one if the firm disclosed RPTs; otherwise, it is coded as zero. Kohlbeck and Mayhew (2010) suggested the use of an indicator variable to represent firms that engage in RPTs instead of attempting to investigate the dollar value of the firm's RPTs for practical reasons. They find that not all RPTs disclosures provide detailed disclosure about monetary implications of RPTs and even in cases where monetary amounts are disclosed, it is not clear which amounts are most relevant – asset, liability, equity or income aspects of the transactions, and the amounts disclosed across transactions are inconsistent (Kohlbeck and Mayhew, 2010). Further, consistent with Allgood and Farrell (2003), we use return on assets (ROA) as a measure of firm value.

Our study controls for a set of factors related to firm value (Size, Leverage, Profitability, Capital Expenditures). We also control for the time and year effect using industry and year dummies. To identify firm industry, we use the Standard Industrial Classification (SIC) system. Table 2 below provides summary of variable measurements.

**Table 2: Variables measurement**

| <b>Variables</b> | <b>Definitions</b>   |
|------------------|--|
| LOGMV            | The logarithm of market value of common equity   |
| RPT              | A dummy variable coded as one if the firm disclosed RPT; otherwise, it is coded as zero. |
| LOGTA            | The natural logarithm of total assets  |
| CAXTA            | The ratio of capital expenditure to total assets   |
| LOGBV            | the logarithm of book value of common equity   |
| ROA              | The operating income divide by total assets  |
| LEV              | The total debt divided by total assets   |

## 5. Results and analysis

### 5.1 Descriptive analysis

The descriptive statistics are presented in Table 3. It shows that the average value of market value (MV) is 6800 in millions. It also shows that the average return on assets of the sample is 4.3% and the average Leverage is 32%. In addition, Table 3 indicates that the Egyptian firms tend to spend less on capital expenditure. Furthermore, the descriptive statistics suggest that around 60 % of firms provide information about related parties, which is relatively high compared to the existing literature.

**Table 3: Descriptive statics of all variables**

| Variables    | Mean  | Median | MAX   | MIN      | SD    |
|--------------|-------|--------|-------|----------|-------|
| MV(millions) | 6800  | 5400   | 36000 | 673      | 6000  |
| LOGMV        | 8.48  | 8.59   | 10.5  | 6.51     | 0.852 |
| RPT          | 0.606 | 1      | 1     | 0        | 0.49  |
| LOGTA        | 16    | 15.7   | 18.4  | 13.8     | 1.13  |
| CAXTA        | 0.034 | 0.012  | 0.51  | 1.60E-04 | 0.06  |
| LOGBV        | 14.6  | 14.7   | 17.2  | 10.5     | 1.35  |
| LEV          | 32.1  | 20.5   | 115   | 0        | 33.7  |
| ROA          | 0.043 | 0.031  | 0.373 | -0.176   | 0.091 |

As shown in Table 4, the correlation matrix suggests that there is a negative relationship between RPTs and market value, but this relationship is insignificant. It also suggests that none of the coefficients are above 80% which in turn suggests the absence of a multicollinearity problem (Field, 2013).

**Table 4: Correlation matrix among all variables**

|       | LOGMV     | RPT        | LOGTA      | CAXTA    | BV      | LEV        | ROA |
|-------|-----------|------------|------------|----------|---------|------------|-----|
| LOGMV | 1         |            |            |          |         |            |     |
| RPT   | 0.1185    | 1          |            |          |         |            |     |
| LOGTA | 0.47***   | 0.5179***  | 1          |          |         |            |     |
| CAXTA | 0.1988*** | 0.1451*    | 0.0961     | 1        |         |            |     |
| LOGBV | 0.4769*** | 0.3645***  | 0.7298***  | 0.127    | 1       |            |     |
| LEV   | -0.035    | 0.4834***  | 0.3961***  | 0.1597** | 0.0313  | 1          |     |
| ROA   | 0.2695*** | -0.2988*** | -0.3329*** | -0.0217  | -0.0648 | -0.4148*** | 1   |

With regard to our control variables, as Table 4 reports, profitability (ROA), size (LOGTA) and Capital expenditure (CAXTA) are positively associated with firm value (See e.g. Eisenberg, 1998; Mehran, 1995). In contrast, the Leverage coefficient (LEV) is found to be insignificant.

## 5.2 Main results

As outlined above, the main objective of this study is to examine the valuation of firms that engage in RPTs. The OLS regression results are reported in Table 5. The main variable of interest, RPTs disclosure, is defined as an indicator variable with a value of 1 if the firm disclosed information about RPTs regardless of the monetary value. Consistent with expectations, our findings suggest that RPTs are not associated with the market's valuation of firms. As shown in Table 5, the coefficient of RPTs is not significant.

**Table 5: The impact of RPTs on Firm value**

| LOGMV           | Coef.  | T value |
|-----------------|--------|---------|
| RPT             | -0.105 | -0.798  |
| LOGTA           | 0.401  | 5.477   |
| CAXTA           | 0.745  | 0.851   |
| LOGBV           | 0.096  | 1.672   |
| LEV             | 4.593  | 6.594   |
| ROA             | 0.001  | 0.66    |
| Constant        | 0.402  | 0.483   |
| Observations    |        | 152     |
| R-squared       |        | 0.44    |
| Industry Effect |        | Yes     |
| Year Effect     |        | Yes     |

As regards the dual effect of RPTs, it is sometimes difficult to determine if transactions are beneficial or detrimental to company performance. This study finds no evidence of positive impact of the existence of RPTs (cf. Djankov et al., 2008; Peng et al., 2011) as well as negative effects stemming from RPTs (cf. Elhelaly, 2014; Gordon and Henry, 2004). This finding is consistent with Kuan et al. (2010), for example, who do not find evidence of a relationship between RPTs and earnings management as a practice that undermines corporate value (see also Pozzoli and Venuti, 2014). Supporting this idea, Huang and Liu (2010), while investigating high-technology firms in Taiwan and China from 1998 – 2008, find that the account (notes) receivables and account (notes) payables from related-party transactions of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance. However, the sales or purchases of goods from related party transactions of high-technology firms in China have a significant (negative) relationship with performance. These studies, so does ours, conclude that related party transactions and firms' market value are not correlated and that there is no evidence of a cause-effect relationship between them. Hence, according to this perspective, the existence of such transactions does not necessarily means the existence of earnings management practices or the tendency to achieve personal benefits to management on the account of business owners i.e. practices that undermine firm value.

The reported different finding in this work assures the intermediary role of the context and the local culture in the relationship between RPTs and firm value. This is the contrast to taking a

universal perspective of the impact of RPTs such as the negative view that is mostly reported in the literature. For example, the different finding of this study can be ascribed to the instability of the Egyptian context due to the latest intense political events which broke out at the beginnings of 2011 (see Ahmed et al., 2017; Elmassri et al., 2016); an issue which needs particular investigation.

Finally, unlike expectations and the literature, which suggests that Egyptian companies disregard RPTs disclosures (Dahawy and Covoner, 2007; Harik, 1997), we found that 60 % of investigated firms provide information about related parties, which is relatively high compared to the existing literature. This indicates to the positive impact of the latest rules and regulations regarding RPTs imposed by the concerned regulatory authorities such as CMA and the Egyptian Stock Exchange (Section 2).

## 6. Conclusion

This study brings further evidence from an emerging African context –Egypt – on the impact of RPTs on corporate value, in contrast to the highly investigated Western and Asian contexts. To the knowledge of our mind there is no study that investigates the value relevance of RPTs in an African context.

As regards the effect of RPTs, it is sometimes difficult to determine if transactions are beneficial or detrimental to company performance. Generally speaking, the reported results in the literature are not always clear or consistent. That is, previous studies reported conflicting results concerning the relationship between RPTs and firm value. (Cheung et al., 2009; Pizzo, 2013). This work extends previous research by investigating the impact of RPTs on Egyptian firms' market value as measured by ROA.

In contrast to studies that reported negative influences of RPTs (e.g. Nekhili and Sherif, 2011; Wang and Yuan, 2012) or studies that reported a positive impact of RPTs (e.g. Peng et al., 2011; Shastri and Kahle, 2004); the present work finds insignificant relationship between RPTs and firm value. This result is consistent with Kuan et al. (2010) and Pozzoli and Venuti (2014) who find no evidence of cause-and-effect relationship between RPTs and better corporate performance. This different result suggests that, especially in emerging markets, the existence of RPTs is not necessarily associated with practices that undermine or enhance firm value. This different finding can be attributed to the nature of the Egyptian market as an emerging market and unstable one due to the emergence of the latest political uprisings in the country since the beginning of 2011, an issue which investigation in future research.

This indicates to the role of the context in explaining the relationship between organizational practices and corporate performance. Hence this study stresses the idea that the valuation of firms that engage in RPTs is context-dependent; rather than being universal. This view echoes the idea that it is necessary to examine the impact of RPTs in other nations, because different



nations can have different cultural and political environments and industry characteristics which can have its implications for RPTs. This invites us to critically investigate the implications of the recent volatile political changes in the country for the relationship between RPTs and valuation of firms, which can be the subject of a future study.

In particular, considering the latest political events in Egypt, we believe that a study is needed which investigates the intermediary impact of the political uprisings at the state level on the relationship between RPTs and corporate financial performance. This will require extending the period of investigation to also include some years before the start of the latest revolutions in Egypt which broke out in January 2011, i.e. there should be two periods of investigation before 2011 and after 2011. This is necessary to capture the real impact of political risk on corporate practices and performance, especially on the value relevance of RPTs.

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