

Effects of Related Party Transaction on Financial Performance of Companies, Evidenced by Study of Listed Companies in Nigeria.

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ABSTRACT

This research examined the relation between related party transactions (RPTs) and financial performance of listed conglomerates in Nigeria. Our research specifically sought to determine whether related party transactions has an effect on return on equity (ROE) and net worth (NW) of conglomerates listed on the floors of Nigeria Stock Exchange for a period of 8 years (2008-2015). The data required to calculate the various performance indicators as well as the data on related party transactions were obtained from the audited annual accounts of the companies. The Pearson correlation method was used to examine the correlation between the dependent and the independent variable while the simple regression analysis was used in analyzing the data. The data analysis suggests that related party transactions, does not significantly influence return on equity with the exception of net worth(NW) which proved to be significantly influenced by related party transactions. Our correlation result revealed that most related party transactions correlate positively with the net worth of the companies.

KEYWORD: *Related party transactions (RPTs). Financial performance, Return on equity(ROE), Net worth (NW),*

1 INTRODUCTION

Related-party transactions (RPTs) are considered by the International Accounting Standards No. 24 (IAS 24) with the objective of ensuring that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related-parties and by transactions and outstanding balances with related parties. Related-party transactions are one of the recurring areas of concern raised by recent corporate scandals. Several scandals in the U.S. and other parts of the world have cited related party transactions as a means to manage earnings as well as divert resources from their companies. Accounting frauds in Enron, Tyco, Parmalat, and Satyam are glaring examples of the same. . These transactions according to Kohlbeck & Maydew (2010) are often

diverse complex business transactions between a company and its Managers, Directors, or Principal owners. Transactions between related parties often times due to the influence of the company and the related party to the transaction are not undertaken at market prices and the terms of transaction varies from the normal commercial terms and conditions which may therefore reduce the earnings which would have been available to the company on that particular transaction while also increasing the risk on the company.

2 Theoretical Principles

Related-party transactions are a facet of corporate governance, due to the fact that they are usually comprised of complicated transactions between a company and its managers, directors, subsidiaries and major shareholders (Jian & Wong, 2010). It is a fact that related-party transactions result in higher agency costs due to the alignment of decision-making rights and monitoring rights. According to Gina (2012), some fundamental traditional accounting performance measures such as return on equity, return on assets, earnings per share among others may be affected by related-party transactions (RPTs). A related party relationship could have an effect on the financial performance of a business entity. This is so because related parties may enter into transactions that unrelated parties would not. For instance, an entity that sells goods to its parent company at reduced selling price may not sell on those terms to another customer. Borrowing or lending money at an interest rate that differs significantly from prevailing interest rate may be a result of a related party involvement. It is possible that transactions between related parties may not be made at the same amounts as between unrelated parties. Now, even if related party transactions do not occur, the financial position and financial performance may still be affected by the mere existence of the relationship between related parties. For example, a company may terminate its business relations with a trading partner because it made a substantial investment in a company that is engaged in the same line of business as the former trading partner. Or a business may also be prohibited from engaging in a particular activity by an investor who has controlling interest in the business. In both cases, the mere existence of a related party relationship wields influence over the activities of a company even without undertaking a business transaction. This as noted by Padmini (2012), has serious implication on the performance of the business entities. Although related-party transactions efficiently fulfill underlying economic needs of the company, questions, concerns and uncertainties about the underlying nature of related-party transactions exist.

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged (IAS-24). The parties involved in the transactions could be a parent company and its subsidiaries, affiliates, employees, the principal owner, directors or management of the company and the subsidiaries, or members of their immediate families. Therefore, related-party transactions are common for firms affiliated to business groups, since most group members do a lot of RPTs within their own groups (Chen & Chien, 2007). These transactions are likely to cause wealth transfers out of a company for the benefit of shareholders with a controlling interest (Johnson, Boone, Breach, & Friedman, 2000) For example, sellers may inflate earnings simply by shifting next period's related sales to the current period (Khanna & Yafeh, 2005) or a Chief Executive Officer (CEO) may receive a lower salary (Gordon, Henry & Palia, 2004) and the interest rates on related loans may be unfairly priced, given the potential for default (Shastri & Kahle, 2004).

Related party transactions are a normal feature of business yet it can distort financial reports. Related parties may enter into transactions that unrelated parties would not (Jian& Wong, 2010). For instance, borrowing or lending money at an interest rate that differs significantly from prevailing interest rate may be a result of a related party involvement. Knowledge of transactions, outstanding balances, including commitments and relationships with related parties can affect the way in which the financial statement users might assess the performance, financial position, risks and opportunities of an entity (Corlaciuc& Tudor 2011) According to Amzaleg& Barak (2011), it is possible that transactions between related parties may not be made at the same amounts as between unrelated parties. Even if related party transactions do not occur between related parties, the financial performance may still be affected by the mere existence of the relationship between the related parties. The severity of related party relationship is such that may affect existing business relation as an entity investing in a company as either an associate or subsidiary may be made to terminate its business relations with a trading partner because it made a substantial investment in a company that is engaged in the same line of business as the former trading partner. The mere existence of a related party relationship wields influence over the activities of a company even without undertaking a business transaction. For these reasons, IAS 24 is issued by IASB to encourage transparency of the existence of related party relationships and transactions

While there are large bodies of related party transactions literature, there is limited empirical research that addresses the related party transaction issue in Nigeria. Extant studies on related party transactions have majorly discussed the phenomenon in larger and higher economically significant countries such as China, Taiwan and US (Eg. Chen, Cheng & Xiao, (2011); Huang & Liu (2010); Gordon, Henry & Palia (2004). Prior studies addressing the impact of related party transactions on financial performance recurrently measured financial performance of firms with Return on Assets (ROA) (Eg. Padmini (2013); Chien & Hsu(2010). Existing literature on related party transactions also examined the phenomenon in relation to corporate governance and disclosure requirement and more also the nature of such transaction. (Eg, Gordon, Henry & Palia, (2004); Gina(2012)In view of the above, this research seeks to address gaps in the literature by examining the effect related party transaction has on financial performance of listed conglomerates in the Nigerian Stock Exchange for a period of 8 years (2008-2015) using financial data from the companies audited annual account while measuring company's financial performance with financial performance indicators such as; net worth (NW) and return on equity(ROE) and related party transactions by year-end balances of related party transactions engaged in by the companies for each period.

3 Literature Review

Several studies have reviewed the relationship between related-party transactions and financial performance of companies, although, majority of these studies were carried out in developed countries, specifically, European countries and ROA has been used extensively in the extant literature as an indicator to measure the net return made by a company on the assets it has invested in padmini (2013)

Cheung, Rau &Stouraitis (2006) examined transaction between 232 publicly-listed firms in Hong Kong and their controlling shareholders and directors where expropriation might occur and shows their incidence and valuation effect. Using data obtained from a sample of 328 connected

transactions of these listed companies within 1998-2000 as published by the Hong Kong Stock Exchange and testing the statistical significance of the results collected using bootstrap method it was shown that on average, firms announcing connected transactions earn significant negative excess returns, significantly lower than firms announcing similar arm's length transactions. Companies experienced decreasing profitability when they performed tunneling transactions.

Henry, Louwers, Reed & Gordon (2007) examined 83 SEC enforcement actions involving fraud and related party transactions of U.S companies and documented the role of related party transactions in each case. Loans to related parties were the most frequent type of related party transaction, followed by payments to company officers for either unapproved or non-existent services. The relative frequency of disclosed related party transaction combined with the relative infrequency of financial reporting fraud suggested that their co-occurrence was rare. Based on the above literature, issues on related party transactions and its disclosures are receiving attention.

Chen, Chen & Chen (2009) investigate the influence of comprehensive types of RP transactions on the operational performance of sampled 763 listed companies in Shanghai and Shenzhen Stock Exchanges during 2002 –2006. They find negative relationships between RP_Sales, RP_Loan, RP_Guarantee, and RP_Lease and financial performance (Tobin's Q) when the listed company is the controlled party, However, when the listed company is the controlled party, they find significant positive relationships between RP_Purchase and operating performance (ROA and Tobin's Q)

Kohlbeck & Maydew (2010) examined that stock market's valuation of U.S. firm's that disclose related party (RP) transactions are more developed when compared to those that do not. Using a sample taken from the 2001 S&P 1500, their examination suggested that RP firms have significantly lower valuations and marginally lower subsequent returns than non-RP firms. Market perceptions differed based on partitioning firms by RP transaction type and parties. The results were consistent with the market discounting firms that engage in simple RP transactions.

Chien & Hsu (2010) investigated the relationship between related party transaction and firm performance of public companies listed on Taiwan stock exchange within years 1996-2006. Collecting information of a sample of 6,041 companies from the Taiwan Economic Journal (TEJ) data. The dependent variable was the operating performance which was measured by Return on Assets (ROA). The independent variables were Related Party Sales (RPSales) measured by related party sales divided by total sales, Related Party Purchase (RPPurch) measured by related party purchase divided by cost of goods sold, Gain on Disposal of Assets from Related Parties (RPAG) measured as gain on disposal of assets from related parties divided by total sales, Loss on Disposal of Assets from Related Parties (RPAL) calculated as loss on disposal of assets from related parties divided by total sales, Related Parties Interest Revenue (RPIR) calculated as related parties interest revenue divided by total sales, Related Party Interest Expense (RPIE) measured by related party interest expense divided by total sales calculated as net income divided by average total sales. Multiple regressions were used to test the relationship between the variables. The result revealed that related party sales, interest revenue and interest expense though negative, were statistically significant and the other variables were negative and insignificant thus it was shown that no relationship exist between related party transaction and firm performance. Their findings support the conflict of interest hypothesis that related party

transactions are harmful to the company's interest.

Huang & Liu (2010) in its study of relationship between RPTs and firm value in high technology firms in Taiwan and China between the periods of 1998-2008. The study measured firm value by ROA, ROE, MVA, Tobin's Q. and EVA. Using ordinary least squares method to test its hypothesis, the empirical results show 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. The study found that the link between RP sale and purchase of goods in Taiwan companies is insignificant in relation to the variables of performance however accounts (notes) receivable and accounts (notes) payable from RPTs of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance (Q, ROE, ROA, MVA, EVA) While for Chinese companies it was found The sale or purchase of goods from RPTs of high-technology firms in China has a significant (negative) effect on performance (Q, ROE, ROA, MVA, EVA).

The findings of Kuan, Tower, Rusmin and Zahn (2010) in the relation between earnings management and related party transaction of fifty (50) Indonesian companies between the periods of 2004-2005 supports the efficient hypothesis, revealed that the presence of related party transaction does not always show bigger earnings management.

Examining the link between RPTs and firm performance measured by Tobin's Q (book value of assets minus book value of common equity plus market value of common equity market value of common equity) and ROA of one hundred and sixty-two (462) Malaysian companies Munir and Gul (2011) discovered through regression analysis that RPT is negatively associated with firm performance. Furthermore, that this association is stronger for family firms than non-family firms.

Chen, Cheng & Xiao (2011) Analyzing related party transaction as a source of earning management by addressing the issue of RPTs during a firms Initial Public Offering (IPO) in China. Using 257 Chinese A and B shares of listed companies during 1999-2000 found that controlling shareholders structure operating RPTs in pre-IPO period and these RPTs are positively associated with firm's operating performance. The decline in operating RPTs after IPO contributes to firm's post-IPO long-term underperformance and negatively affects firms' stock return. Thus RPTs does affect the performance.

4. Research Hypothesis

The impact of related party transaction in business is one that can't be avoided. The management have privileged right to information and may use this knowledge in the business trading. An investment decision may have been initiated in abid to take advantage of a failing business, it is possible that transactions between related parties may not be made at the same amount with an unrelated party. Munir and Gul (2011) discovered that related party transaction is negatively associated with firm performance.

Hi: Related party transaction significantly influence return on equity of listed companies in Nigeria

Hi: Related party transaction has significant relationship to the net worth of listed companies in Nigeria

5.0 Methodology

The Ex-post facto research design was adopted because it seeks to establish the factors that are associated with certain occurrence or type of behaviour by analyzing data contained in financial statements.

Research Population

The study population comprised of all listed conglomerates on the Nigerian Stock Exchange. As at 31st December, 2015, there were six conglomerates. These companies are A.G.Leventis PLC, UACN PLC, JOHN HOLTS PLC, Chellarams PLC, Transnational Corporation PLC and SCOA PLC. The choice of conglomerates as a population of study is because conglomerates companies comprises of several smaller companies which conduct business separately it therefore becomes evident that there would be inter-company transaction among these companies. The smallness of the population however cancelled the use of samples and sampling techniques.

The study covers the period 2008-2015 (a period of 8years). The choice of this period was based on the most recent years for which data were available. Related Party Transactions (RPTs) of the Companies as obtained from notes in the annual accounts of the companies were used as proxy to measure *RPTs*.

Definition and variable measurement

The dependent variable for this research is the financial performance of business which is proxied by return on equity (ROE) and net worth (NW) while the independent variable is the related party transaction which is a summation of Directors divined, key personnel management emolument, Rp Expenses, Transactions with key personeel management, and Rp_Guarantee of these conglomerates for the period 2008-2015.

$$\begin{aligned}\text{Returns on Equity (ROE)} &= \frac{\text{Profit After Tax}}{\text{Equity}} \\ \text{Net Worth (NW)} &= \text{Log}_{10}(\text{Total Asset s- Total Liabilities}) \\ \text{Related party Transaction (RPT)} &= \text{Rp_Receivables} + \text{Rp_Sales} + \text{Rp_Expenses} \\ &\quad + \text{Transactions with Key mgt} + \text{RP_Guarantee}\end{aligned}$$

Data Analysis

To measure the strength or degree of linear association between the dependent and independent variables the correlation coefficient was used. The F-statistical tool was used to test the hypothesis and the regression model was tested using the adjusted r^2 and F statistics through the Statistical Package for Social Sciences (SPSS 20.0 version).

a simple regression model was used to analyze the data and test each of the hypotheses in line with the study of Minur&Gul (2011) and Ching, Ling & yuang (2015). The study tests the independent variables (RPTs) and how it influences the performance of the Company's. The model for the study was based on the functional equations below:

$$ROE = F(RPTs)$$

$$NW = F(RPTs)$$

The Regression equation are state as follows

$$ROE_{it} = \beta_0 + \beta_1 RPTs_{it} + \varepsilon_t$$

$$NW_{it} = \beta_0 + \beta_1 RPTs_{it} + \varepsilon_t$$

Where

RPTs	=	Related-Party Transactions
ROE	=	Return on Equity
NW	=	Net Worth
ε	=	Error Term (variables not captured in the model)
it	=	Time Period
β_0 ,	=	Constant of regression equation
β_1 ,	=	Regression Coefficients

5. Result and Discussion

Result of Correlation

The result of correlation matrix for the variables is reported in order to examine the correlation between the dependent and independent variables. The results show that Return on equity (ROE) has a positive relationship with RPT_receivables, and transactions with key management while the rest of the variables showed a negative relationship with ROE. The net worth of the firms showed a positive correlation with all the constituent variables of RPT.

Testing of Hypothesis

The hypotheses were tested using F-statistic tool. Simple regression analysis was used to measure the impact of the independent variables on the dependent variables. The regression models were also tested.

Hi: Related party transaction significantly influence return on equity of listed companies in Nigeria

Table 1.1 Model Summary for Hypothesis 1

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.134 ^a	.018	.012	.08770

a. Predictors: (Constant), total rpt

Source: SPSS Version 20

Table 1.2 ANOVA for Hypothesis 1

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	.005	1	.005	.600	.444 ^b
Residual	.254	33	.008		
Total	.258	34			

a. Dependent Variable: return on equity

b. Predictors: (Constant), total rpt

Source: SPSS Version 20

Table 1.3 Coefficients for Hypothesis 1

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.047	.058		.805	.427
total rpt	.007	.009	.134	.775	.444

a. Dependent Variable: return on equity

Source: SPSS Version 20

The regression coefficient of Related Party Transactions is 0.007. The correlation coefficient, 0.134 shows a positive relationship between determination (R^2) 0.012 shows that the model has 1.2% of determination. Related Party Transactions was seen to have extremely low predictability in the determination of ROE. Restating the regression equation,

$$ROE = 0.047 + 0.007RPT_j + \epsilon_j$$

For the decision making we would accept null hypothesis if p -value is greater than the level of significance and reject null hypothesis if otherwise. Table 4.4 above shows that $F(1, 33) = .600$ and $p(.444) > .05$, from the decision rule, we reject the alternate hypothesis and accept the null hypothesis that Related Party Transactions do not affect Return on Equity.

Hypothesis 2: RPTs and Net-worth

Hi: Related party transaction has significant relationship to the net worth of listed companies in Nigeria

Table 2.1 Model Summary for Hypothesis 2

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.460 ^a	.212	.188	2.57308

a. Predictors: (Constant), total rpt

Source: SPSS Version 20

Table 2.2 ANOVA for Hypothesis 2

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	58.704	1	58.704	8.867	.005 ^b

Residual	218.484	33	6.621		
Total	277.188	34			

a. Dependent Variable: net worth

b. Predictors: (Constant), total rpt

Source: SPSS Version 20

Table 2.3 Coefficients for Hypothesis 2

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	.699	1.700		.411	.683
total rpt	.795	.267	.460	2.978	.005

a. Dependent Variable: net worth

Source: SPSS Version 20

The regression coefficient of Related Party Transactions is 0.795. The correlation coefficient 0.460 shows that RPTs affect net-worth positively. The adjusted R^2 shows the predictability of the model. The coefficient of determination (R^2) 0.212 shows that the model has 21.2% of determination. Related Party Transactions was seen to have some level of predictability in the determination of Net worth. Restating the regression equation,

$$NW = 0.699 + 0.795RPT_j + \epsilon_j$$

We would Accept null hypothesis if p -value is greater than the level of significance and reject null hypothesis if otherwise.

Table 2.13 above shows that $F(1, 33) = 8.867$ and $p(.005) < .05$, we accept the alternate hypothesis and reject the null hypothesis that Related Party Transactions does not significantly affects Net-worth.

6. Discussion and Conclusions

Transactions of companies with related party transaction based on the research result as evidenced does not affect the financial performance of companies. This implies that dealings with member of management and company shareholders has no impact on the returns of the company and so management could This finding is similar to Kuan, Tower, Rusmin and Zahn (2010) Huang and Liu (2010) in Taiwan high technology and Waidari, Subroto and Fuad(2016) using multi-regression analysis. Contrary to our findings, Kohlbeck and Maydew (2010) using the residual income model of valuation analysis found a positive relationship between RPTs and equity returns. In relation to the relationship of RPTS and Net worth a positive and significant relationship was seen among all the RPT variables indicating that the existence of related party transaction affect the value of a firm. This is in agreement with the findings of Kohlbeck and Mayhew (2010) using sensitivity analysis that RP firms have significantly lower valuations review and that the market assigns lower values to firms that engage in relatively simple RP transactions including loans. In contrast, complex transactions with investments are not valued

negatively.

Conclusion

The findings of this research suggest that related party transactions do not significantly influence the financial performance of the Nigerian conglomerates. Returns on companies assets and the earnings available to shareholders on their investment, isn't affected by the existence of RPTs. The existence of related party sales also does not affect the net profit ratio of the companies. However, it was found that RPTs has significant influence in determining the net worth of companies which implies that related party receivables, Loans and payables if uncontrolled may rise to eventually affect the return on assets. Related party transactions however, should be minimized to avoid the likelihood of transgressing into a fraud opportunity for management.

This research contributes to the existing research on RPTs in different ways. Firstly, the literature regarding the examined issue; the association between RPTs and financial performance is still limited, and in many cases emphasis is on selected companies in East Asian countries (China, Indonesia, Malaysia and Taiwan) and the United States of America. This study carries out this analysis on Nigerian conglomerates, and thus on a specific market within Western Africa.

Secondly, this research takes into consideration the likely financial effects arising from RPTs. The variables used were extrapolated from the official financial statements of the companies and can be addressed as being free from discretionary bias. The results of the conducted analysis, confirms that related party transaction significantly affect financial performance in one way or the other. In particular, our results show that RPTs and companies' financial performance results are not correlated for Nigerian conglomerates. There was evidence to the contrary in the case of the firms' net worth as it showed a positive and significant relationship

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