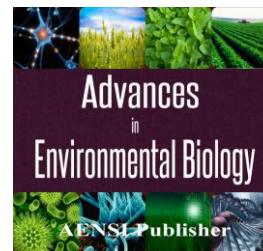




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The Relationship Between Related Parties Transactions with Institutional Ownership (Long/ Short Term) and Firm's Board of Directors

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ABSTRACT

Background: The purpose of this study is to assess the relationship between related parties sanctions with institutional ownership (long/ short term) and firms' board of directors. In this research, financial information of 100 firms listed in stock exchange of Tehran during a period from 2003 to 2011 is considered. Results show that there is a significant inverse relationship between the ratio of outside board members and rate of transactions with related parties (trade in goods and trade in financial resources with related parties). Eventually, results show that there is a significant direct relationship between long-term institutional ownership and rate of related parties transactions (trade in goods and trade in financial resources with related parties).

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INTRODUCTION

Related parties transactions, apart from obvious and proclaimed motives to do them, may happen with the aim of hiding self-interest (limited number of people) in the expense of shareholders of the firm. Benefitting leverages such as sell (buy) of assets, goods and/or services to (from) another firm in a price higher (lower) than market, related parties may attempt to gain personal benefit in the expense of firm and other shareholders. Related parties may also seek their personal gain thorough facilities they receive with appropriate conditions.

Two common mechanisms used in corporate governance systems are firm's outside board members and institutional owners present there. Regarding power of exercising control on firm and its decisions, composition of the board is a factor influencing transactions with related parties.

According to what mentioned before, in this study, it is tried to investigate the amount of influence by institutional ownership and firms' board of directors composition on transactions made with parties related to firms. Accordingly, the inverse expectable relationship between institutional ownership and firm's board composition and related parties transactions among firms listed in stock exchange of Tehran is assumed and tested, arguing that appropriate corporate governance mechanisms improve fair unbiased dealing with variable shareholders (minority and majority).

Generally speaking, in scientific literature related to related parties transactions, two conflicting views on the effect of these transactions on firm's performance are observed which are:

- Conflicting interests view related to transfer of wealth, proponents of which consider transactions as potentially harmful and believe that transactions with related parties are not always beneficial to the firm and they are usually for the benefits of managers (major shareholders).
- Efficient transactions view related to improvement, proponents of which consider transactions as suitable, economic exchanges and beneficial for majority of shareholders. They believe that related parties transactions improve financial status and performance of the firm.

Table 1: Views on related parties transactions.

Theories framework	Efficient transactions view	conflicting interests view
Interpretation of related parties transactions	Healthy economic exchanges	Unhealthy economic exchanges
Regulatory implications	Disclosing terms of transactions, determining appropriate regulatory mechanisms	Detailed disclosure of transactions, approval by the board, prohibition of certain activities

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Most of studies conducted in different markets show that related parties transactions is a tool for exploitation of minority shareholders rights. Additionally, research carried out on market reaction show that firms holding transactions with related parties have less market value.

Types of institutional investors:

Institutional investors can be divided into two passive and active groups.

Passive institutional investors have high portfolio turnover and moment trading strategy. As an example, they buy stocks as they receive good news and sell receiving bad news. For these owners, current stock price is crucial. They hold short-term transient views believing in current performance preferable to long-term performance of the firm. Therefore, they do not have high motive to regulate management or have representation in board of investment-demanding firms.

However, active institutional investors hold long-term views considering firm's long-term performance. As a result, their motive to have representation in board of investment-demanding firms is high. Low portfolio turnover of great investors shows their high motive to hold share and encourage managers to improve operations and increase shareholders wealth. Almazan *et al* found out that the more active institutional ownership, the more supervision on managers and adopted procedures by them will be.

Research background:

- 1) Yeh *et al* studied the effect of corporate governance system on transactions with persons in stock exchange of Taiwan. Results show that corporate governance system reduces related parties transactions. The relationship, using surrogate criteria in measuring different types of related parties transactions like; sales, lending, guarantees and borrowing, was significant.
- 2) Nakhili& Cherif 1 studied the relationship between related parties transactions and firm value in French firms and their corporate governance structure. Results showed that related parties transactions are highly influenced by voting right of firm's major shareholders, board size and degree of independence of audit committee and board from executive managers.
- 3) Lei& Song 2 studied related parties transactions role in earnings management results of which showed that firms try to transfer wealth to original owners by related parties transactions. Investors too are not willing to invest in such firms and market value of these firms drops considerably.
- 4) In a research, Peng *et al* 1 concluded that main shareholders intend to acquire assets and income through wealth transfer by related parties.

Hypotheses:

First hypothesis: there is a reverse relationship between proportion of outside board members and number of related parties transactions

1-1: there is a reverse relationship between proportion of outside board members and related parties trade in goods.

1-2: there is a reverse relationship between proportion of outside board members and related parties trade in financial resources.

Second hypothesis: there is a reverse relationship between short-term institutional ownership and related parties transactions.

2-1 there is reverse relationship between short-term institutional ownership and related parties trade in goods

2-2 there is reverse relationship between short-term institutional ownership and related parties trade in financial resources

Third hypothesis: there is a reverse relationship between long-term institutional ownership and related parties transactions

3-1 there is a reverse relationship between long-term institutional ownership and related parties trade in goods

3-2 there is a reverse relationship between long-term institutional ownership and related parties trade financial resources

Research method, population, sample and sampling method:

Research population is all the firms listed in stock exchange of Tehran from 2003 to 2010. Sample was selected by screening method and following criteria:

- 1) Full information and notes with financial statements of firms must be accessible.
- 2) Full information of each firm studied for two years before research time limit must be present.
- 3) Firms are not supposed to undergo any fiscal year change during research period.
- 4) Type of firm's activity must be production and financial institutions, investment, banks, insurance firms, leasing and holding firms are not included in the list.
- 5) End of fiscal year of firms considered is the last day of the year (March 20).

Table 2: Operational definition of variable.

Symbol	Type of variable	Name of variable	Measuring method
RPT 1	dependent	Goods trade	Total amount of sale/purchased values divided by firm's beginning total assets
RPT 2	dependent	Financial resource trade	Total amount received or granted for financing to related parties divided by beginning total assets
CEO	independent	Ratio of outside members	Ratio of outside board members to total number of board members
INSTI L	independent	long-term institutional shareholders ownership	Long-term institutional investors are supposed to have following requirements: Active member of board High ownership concentration for four years High stock market value for each year
INST S	independent	short-term institutional shareholders ownership	Institutional owners meeting all requirements are considered as long-term and others as short-term institutional owners
Size	control	Firm size	Natural logarithm of firm's total assets at the balance sheet date
Grow	control	Growth of assets	change in total assets divided by beginning assets of the firm

1-4 Descriptive statistics:

Data analysis in this section is carried out using indices like mean, statistical dispersion and SD.

Table 3: Descriptive statistics of research variables.

Variable	views	mean	SD	Minimum amount	Maximum amount
Related parties trade in goods	800	0/1378	0/1996	0/0000	1/7531
Related parties trade in financial resources	800	0/2853	0/3562	0/0000	2/3296
Related parties transactions	800	0/4232	0/5402	0/0000	3/9844
proportion of outside board members	800	0/4260	0/1650	0/1429	1/0000
Proportion of short-term institutional ownership	800	0/4299	0/1986	0/0000	1/0000
Proportion of long-term institutional ownership	800	4/0619	0/4521	0/0000	4/6052
Growth rate	800	0/6863	2/3111	-0/9994	28/9430
Firm size	800	13/1122	1/4391	9/6915	18/3655

The average proportion of outside board members and short/ long-term institutional ownership of sample firms is positive during research period and their values are 0.4260, 0.4299 and 4.0619 in order. Additionally, positive mean for firm's growth rate and its size is 0.6863 and 13.1122.

Summing up and conclusion:

In this research, a brief descriptive statistics of research variables is provided. In the following, inferential statistics and research models in the form of inferential hypotheses are presented. In order to examine models, first, Chow test is applied to determine whether Panel or combined approach should be used and in the following, Hausmann test is applied to use random effects or fixed effects panel. Eventually, model fitting and results from classic regression hypotheses for research models are provided.

1) Research results in connection with hypotheses 1, 1-1 and 1-2 showed that there is a reverse significant relationship between proportion of outside board members and related parties transactions, related parties trade in goods and related parties trade in financial resources confirming conflict of interests since proponents of this viewpoint consider these transactions as potentially harmful and believe that related parties transactions are not in favor of firms and they are usually in benefit of managers (major shareholders). As a result, as the proportion of outside board members increases, we can move in line with conflict of interests view.

2) Results in connection with rejection of hypotheses 1, 1-1 and 1-2 showed that there is no reverse significant relationship between short-term institutional ownership and related parties transactions, related parties trade in goods and related parties trade in financial resources.

3) Eventually, research results in connection with confirmation of first part of hypotheses 3, 3-1 and 3-2 and rejection of their second part showed that there is a direct significant relationship between long-term institutional ownership and related parties transactions, related parties trade in goods and related parties trade in financial resources confirming effective transactions viewpoint since proponents of this view consider the transactions as useful economic ones and in benefit of all shareholders believing that related parties transactions improve performance and financial status of firms. Therefore, with an increase in long-term institutional ownership, related parties transactions increase as well, moving in line with effective transactions.

Practical suggestions:

- 1) Long-term institutional owners have a positive significant relationship with related parties (trade in goods and financial resources) therefore, in order to regulate transactions with related parties (normal and abnormal), long-term institutional owners can have a direct influence.
- 2) Short-term institutional owners have high influence on related parties transactions so it is recommended that this corporate governance criterion be not applied for regulation of related parties transactions (normal-abnormal).
- 3) Adjusted role of outside board members can limit related parties transactions so it is recommended that in case any restrictions is required for related parties transactions, superiority of outside board members is considered in board composition.

Suggestions for future studies:

- 1) The effect of type of industry on relationship between related parties transactions with institutional ownership (short/ long term) and firms' board of directors.
- 2) Relationship between transactions with normal and abnormal related parties with institutional ownership (long/short term) and composition of firm's board of directors.
- 3) Relationship between related parties transactions with long/short term institutional ownership and composition of board in terms of representation theory.

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