RELATED PARTY TRANSACTIONS AND CORPORATE GOVERNANCE MECHANISMS: EVIDENCE FROM FIRMS LISTED ON THE KARACHI STOCK EXCHANGE

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Abstract

This study has investigated the impact of corporate governance mechanisms on related party transactions of Pakistani firms. A sample of 160 non-financial firms are used for the analysis that has reported related party transactions in their annual reports for the sample period 2006 to 2012. The empirical results of different regression models suggested that board independence, blockholdings and institutional ownership play a vital role in the internal governance mechanism. While associated firm ownership, CEO-duality and managerial ownership act as agents that expropriate minor shareholders wealth through related party transactions. Moreover, banking loan, multiple banks in relation and audit quality act as external governance agents and can mitigate the conflict of interest between the minor and major shareholders. These agents may lessen the expropriation through related party transactions by major shareholders, there by securing the interest of minor shareholders.

Keywords: Related party transactions, corporate governance, ownership structure, associated companies, Pakistan.

JEL Classification: G 200

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Introduction

Related party transactions are recurring transactions of concern to the academia and practitioner due the recent corporate scandals. These are diverse complex business transactions with managers, owners, directors, associated firms etc. The inherent complexity of these transaction leads to audit risk as these transactions are difficult to be audited (AICPA 2001, Johnstone and Bedard 2004). The General Accounting Office (2003) acknowledged that related party transactions are used by companies to restate their financial statements and thus these transactions are considered as one of those nine reasons which help firm manager’s to manipulate financial statements according to their will. Thus, regulatory bodies, market applicants, and stakeholders consider these transactions as potential conflict of interest that violate agency responsibility of manager’s as well as the monitoring function of corporate board of director. This conflict of interest hypothesis regarding related party transactions is consistent with agency problem as reflected in the research studies of Berle and Means (1932) and Jensen and Meckling (1976). Classens et al.;(2002) suggested that the risk of expropriation of minority shareholders by large, controlling shareholder is an important principle-agent problem in most of the emerging economies. The conflict of interest hypothesis become more prominent after corporate scandal of Enron, Adelphia and Tyco.


The rest of the paper is organized as follow: The literature section provides an overview of the different competing hypothesis of the
related party transactions. Methodology section discusses the type of investigation, dataset, model and definition of variables. The analysis section shows descriptive statistics, correlation and regression results with interpretation and policy recommendations.

Corporate Governance and Related Party Transactions

Corporate governance is considered as a stand alone solution to control the conflict of interest among the different stakeholders. Shleifer and Vishny (1997) define corporate governance as a mechanism through which suppliers of finance ensure their returns on their investment. The importance of the corporate governance arises due to the separation and distance between the shareholders (owners) and managers (Epps & Cereola 2008, Zubaidah et al; 2009). Yermack (1996) suggested that large boards can face a communication problem that may reduce their efficiency. However, in emerging economies where there is week communication system and information sharing and processing is inefficient, small board is preferred. As small board have more effectiveness as fewer member enhance sharing and information processing (Klein, 2002[a]; Bushman, Chen, Engel and Smith 2004; Yermack, 1996). Moreover, small board monitoring ability is far better than large board size and thus small board have positive impact on the firm performance (Yermack, 1996, Padmini 2013).

Hypothesis 1. In a reasonable range, small board size help to reduce related party transactions due to their good monitoring ability.

Fama and Jensen (1983) suggested that large board size and more independent directors are the two keen factors that can reduce the agency conflict as posed by the related party transactions. Independent directors are the outsider directors who never been the part of the firm before becoming member of the board. Thus these independent directors are expected to work in the best interest of

Hypothesis 2. A high percentage of outsiders in the board of directors is negatively associated with related party transactions.

Moore (2002) suggested that efficient firm’s operations there must be at least six meetings per year in alternative months. Ward (1991) suggested that board should meet four times per year, additionally monthly executive’s committee meetings must be attend by these directors and CEO. Gao and Kling (2008) reported on average six meeting per year during 1998 to 2002. Their study evidenced more dispersions in board meeting ranges from 1 to 37. Pakistani Code of Corporate Governance (2002) suggested quarterly meeting attend by each directors, moreover meeting detail, attendance of each director, meeting minutes should be maintained.

Hypothesis 3. The number of board meetings is negatively associated with the related party transactions.

The theoretical literature on the agency theory long suggested that opportunistic behavior of the agent (manager) can be altered by the substantial compensation attached with firm’s performance. So managers can work harder and select the best investment project in order to raise their incentives (Holmstrom 1979; Holmstrom and Hart 1987). Jensen and Murphy (1990) measure pay performance sensitivity and suggested small value of CEO’s pay to performance sensitivity which is $3.25 per $1000 increase in the wealth of the shareholders. However, Hall and Gao (1998) are of opine that pay-performance sensitivity is not too much low and suggested a small change in the firm value brings large changes in shareholder’s wealth (Larcker 2002, Amzaleg and Barak 2011).
**Hypothesis 4.** There is negative association between the related party transactions and CEO compensation.

In emerging markets business group act as a major shareholder which control other associated firms in group through their pyramid structure of ownership. These business groups can conduct related party transactions with aim of expropriating the firm assets and profits (Jian and Wong, 2004). However, Jordan and Prithwiraj (2012) suggested that business group play important role in the overall growth of human resource and technological development of the member firms. They clearly showed in there research that group firms perform better than stand-alone firms in terms of profitability, growth and market performance.

**Hypothesis 5.** Associated firm ownership has positive association with related party transactions.

In the context of the corporate governance, CEO-duality means that the post of CEO and Chairman is held by one person. Fama and Jensen (1983) suggested the separation of control from the ownership can better restrain the agency conflict and may enhance the firm value. However, in emerging economies, duality of leadership is common as firms are dominated by families and groups (Chen et al; 2005). Moore (2002) identified that in order to keep focus on the firm leadership, companies keep CEO’s as the board chairman. Gordon et al, (2005) are of the opinie that CEO-duality may weaken the board independence and thus have negative impact on the firm performance. **H6. There is positive association between CEO-duality with related party transactions.**

**Research Designed and Methodology**

Sample of the study is comprised of 160 firm’s listed with Karachi Stock Exchange for the period of 2006 to 2012. This sample was primarily determined by the availability of annual data for the
same period from different industry like cement, textile and spinning, engineering, chemicals transportation, telecommunication, foods, gas, and pharmaceutical. The study has initially looked for the sufficient number of companies that reported related party transactions and they have followed corporate governance code 2002 and 2012 rules regarding evaluation and disclosure of related party transactions. The data collected from the annual reports of the firms which were downloaded from the individual firm websites.

Research Model

Causal Factors and Related Party Transactions

In order to investigate the impact of corporate governance, ownership structure, external auditor and bank monitoring on related party transactions as shown below in the following equation 1.

\[
RPT_i = \alpha + \beta_1 BS_i + \beta_2 HED_i + \beta_3 BM_i + \beta_4 CEO - COMP_i + \beta_5 CEO - Durity_i + \beta_6 ASSG - DSP_i + \\
\beta_7 CEO - Durity_i + \beta_8 Audit - Quality_i + \beta_9 Bank - Loan_i + \beta_10 Mult - Bank_i + \beta_11 LEV_i + \\
\beta_12 F - Size_i + \beta_13 F - GB_i + \epsilon_i
\]

i. Dependent Variable

In the above model RPT\(_i\) stands for the related party transactions which is consider as a proxy for operational tunneling. It is calculated as difference of related party account receivables and payables divided by total assets of firm (Gao and Kling, 2007). Similarly for the robustness checks, the study also considered sales and purchases with related parties as a proxy for tunneling (Gordon et al. 2004 and Henry et al. 2007). Higher and positive value of RPT suggests more expropriation by controlling shareholders and vice versa. If firm engaged in transactions with associated firms is regarded as related party transactions and have to be disclose in firm annual report as these transactions are believed to be detrimental to shareholders wealth.
ii. Independent Variables

The study includes all important variables that have been identified in the literature as determinates of RPT. These variables includes corporate governance variables such as board size (B.S) which is computed as the number of board of directors of the firm (Fama and Jensen, 1983, Gao and Kling 2007, Nekhili and Cheirf 2011). NED stands for non-executive directors or the outside directors; it is computed as percentage of outsider directors to total directors (Gao and Kling 2008). B.M stands for the board meetings and it has been computed as number of board meetings conducted in year (Ward 1991; Moore 2002; Gao and Kling 2008). CEO.Comp is proxy for CEO-compensation and has computed as natural log of the annual salary of CEO. The higher is the CEO compensation the lower would be the related party transactions (Core, Holthausen and Larcker 1999; Gao and King, 2007). CEO.Duality means dual charge vested in one person. Its value is 1 if the chairman is also member of the board otherwise 0. If both type of designation are vested in one person means that he has more power to expropriate (Felton and Watson 2002; Gao and King, 2007).

Ownership variables include INST which stands for percentage institutional ownership and it is computed as institutional share ownership to that of total share ownership of the firm (Tang et al. 2004; Gao and King, 2007). M.O represent percentage of share held by managers, CEO, their child and spouse. It is computed by managerial share ownership divided by total share ownership (Gibson 2003; Santiago-Castro and Brown 2011).

Audit.Qual stands for the audit quality. It is calculated by the total fee paid to the auditor. The higher reputed firm would charge more fee and will do high efforts to analyze firm financial accounts at their best (Gao and King 2008). Multi.bank stands for multiple banks in relationship. It is computed by the number of banks from which the firm has taken loan or is in transactions (Sungyoon and Choi 2008).
Consumer Innovativeness Leading to Innovation Adoption

Bank Loan is proxy for the amount of loan taken by firm. It is computed as bank loan to total liability (Qian, Pan and Yeung 2011).

Results and Discussion

The section presents results from different types of analyses to test the hypotheses.

Descriptive Statistics

Table 4.1 shows the descriptive statistics of the related party transactions, governance variables, financial firm-specific variables and firm performance. DRPTRP stands for difference of related party receivables to payables. Its minimum value is -0.3828, its maximum value is 0.2928, while its mean value is -0.0300. The statistics show that expropriation of firm assets goes up to the maximum of 38.82% while on average this happens up to -3% through the related party transactions. DRPTSP stands for difference of sale to purchases with related parties. It has a minimum value of -0.6863 while its maximum value is 0.3651 and its mean value -0.0233. These statistics further suggests that firm assets have been expropriated up to 68% through the related party transactions. On average 2.33% of the firm’s assets have been misappropriated by the associated firms in our sample firms. Other variables such as board size, board independence, CEO-duality, board meetings, associated ownership, controlling ownership 20% and 30%, number of banks in relationship, bank loan amount and audit fee is given in Table 4.1.

Table 4.1 includes Governance factors: bard size, Board independence, board meetings, CEO-dual, compensation of CEO, % of associate ownership to total ownership, CS20% and CS30%. Firm size, firm growth leverage and profit are control variables.

Pearson Correlation Matrix

Pearson Correlation table 4.2 shows association between different variables. Board size, board meetings, CEO-
duality, associated ownership are positively correlated with related party transactions. Whereas board independence, CEO-compensation, controlling shareholders ownership 20% and 30% are negatively correlated with related party transactions.

Table 4.1

Descriptive Statistics

<table>
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<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std</th>
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Table 4.2 includes Governance factors: board size, Board independence, board meetings, CEO-dual, compensation of CEO, % of associate ownership to total ownership, CS20% and CS30%. Firm size, firm growth leverage and profit are control variables.
Table 4.2

Pearson Correlation Matrix

<table>
<thead>
<tr>
<th></th>
<th>DRPTSP</th>
<th>B.IND</th>
<th>CEO</th>
<th>CEO-COMP</th>
<th>ASSOT.GRP</th>
<th>CS20%</th>
<th>CS30%</th>
<th>F.Size</th>
<th>F.Grwth</th>
<th>LEV</th>
<th>TANG</th>
<th>PROF</th>
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</thead>
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<tr>
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<tr>
<td>CEO</td>
<td>0.06</td>
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<td>CS20%</td>
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Related Party Transactions and Corporate Governance Mechanism

Table 4.1 shows the results of regression analysis of the equation-I as shown above.

The results suggest that board size is positive significant relationship with related party transactions (RPTs). This might be due to the inefficiency of larger boards. In fact literature supports this view to some extent. For example, Klein (2002) suggested that small board is more effective in firm decision making and monitoring capability due to sharing and processing of information. Similarly, several other studies supported the effectiveness of smaller board (see, e.g, Bushman et al; 2004; Yermack, 1996; Li (2005) and Gao and Kling 2008). Similarly, board independence is significant negative relationship with RPTs. This result is aligned with the studies of Fama and Jensen 1983; Fama 1980; Gordon et al; 2005 and Gao and Kling 2008. Board meetings found positive and significant relationship with the RPTs. The higher board meetings would be an indication of the higher number of RPTs as all such transactions
needed to be approved in the board of directors meetings, as a statutory requirement. These results are consistent with the study of Gao and Kling (2008) suggested positive association of the board meetings with the RPTs. CEO-duality is also positive significantly related with RPTs. These results are supportive to Chen et al. (2005) that in emerging economies duality of leadership is common, as firms are dominated by families and groups. The dual power of the CEO would help him to divert resources towards the associated firms and thus expropriate the minor shareholders through RPTs (Gordon et al; 2005). CEO compensations is significant negative relationship with RPTs. Gordon et al; (2005) also verified negative impact of CEO-compensations on RPTs. On the basis of these results, it may be inferred that internal governance mechanism play a vital role in reducing negative impact of the RPTs.

The existing research shows the dominance of family firms and associated firms in Pakistan. That is why associated ownership is significant positive relationship with RPTs as consistent with Gao and Kling (2008). Controlling shareholder having ownership of 30% other than associated ownership is significant negative relationship with RPTs. However, ownership of top 20% has negative coefficient but insignificant. The results highlighted that as the controlling ownership increases its impact on RPTs also increases in family controlled firms (La Porta et al.1999; Claessens et al. 2000 and Gordon et al. 2005). Managerial ownership is significant positive relation with RPTs. As Pakistan is an emerging economy and is characterized by ownership concentration, firms are dominated by families and the family members own major portion of the firm stock in many grouped firms. Thus the higher the managerial ownership the higher would be the expropriation of the minor shareholders through the diversion of assets or funds to the other associated or grouped firms (Teoh, Wong, and Rao 1998, Maury 2006). The results are consistent with the Gordon et al; (2005) but contrary to the Gao and Kling (2008) suggested negative relationship due to the difference in the ownership pattern.
As Chinese firms are dominated by the state ownership where managerial ownership play vital role in securing minority shareholders rights. However, Pakistani firms are dominated by family managerial ownership which strengthens the conflicts of interest with the minor shareholders. Institutional ownership has insignificant relationship with the related party transactions as the sample companies consist of all those firms having related party transactions dominated by family managerial ownership and associated firm.

Bank loan is significant negative impact on RPTs. These banks seeking to be repaid their loan installment, have incentives ensure that associated firm managers do not expropriate firm assets and thus severs as external monitoring agent (Jensen and Meckling 1976; Leftwich 1983; Watts and Zimmerman 1990). Moreover, number of banks have negative association with RPTs but the coefficient is not significant. The insignificant results may be attributed to the fact that, fixed assets such as plant and machinery are financed through consortium of different banks. Multiple banks are there in relation to the firm but their monitoring role is played by the one which is leading the contract. Audit quality is significant negative relationship with RPTs. Thus improvements in the audit quality would reduce the assets and funds expropriation through RPTs (Weber et al. 2008 and Skinner and Srinivasan 2011). Thus these two external governance tools are proved to be effective in reducing the minor shareholders expropriation through RPTs in case of associated firms.

Moreover, the firm specific control variables such as firm size is significant positive association with RPTs while firm growth, firm tangibility, leverage and profitability is insignificant but negative relationship with RPTs. While difference of related party sale to purchases has used as dependent variable as shown in the table 4.3 and model 3 and model 4. The results are similar to the baseline estimation. Board size, board meetings associate ownership has
positive significant relationship with RPTs. Moreover, board independence and CEO compensation has significant negative relationship, while CEO-duality and associate ownership, controlling ownership at 20% and 30% insignificant relationship with RPTs.

### Regression Analysis of Related Party transactions and Corporate Governance

The below shows results of regression analysis where dependent variables is difference of related party receivable and payable.
payables and second proxy is difference of related party sale and purchases. Whereas the independent variables such as Governance factors includes a group of variables as such as B.S stands for the board size and it is computed as log of number of board members, B.IND stands for Board independence is computed as number of non-executive director divided by total directors, B.MET stands for board meetings and is computed as log of total number of board meetings. CEO-dual stands for CEO-duality and is equal to 1 if chairman and CEO position is held by same person otherwise 0, CEO-COMP stands for monetary compensation of CEO and is computed as log of annual salary of CEO, ASSOT.OSP stands for percentage of associate ownership to total ownership, CS20% and CS30% stands for the major shareholders top 20% and 30% who own major shares of the firm act as block holders.

Control variables include F.size means firm size and is computed as log of total assets. F.Growth stands for firm growth and is computed as changes in the firm fixed assets, LEV stands for the leverage ratio and is computed as debts divided by total assets, TANG stands for tangible assets and it is computed as fixed assets divided by total assets, PROF mean firm net profit margin. Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Random and Fixed Effect Regression Analysis of Related Party Transactions and Corporate Governance

Table 4.1 includes Governance factors: bard size, Board independence, board meetings, CEO-dual, compensation of CEO, % of associate ownership to total ownership, CS20% and CS30%. Firm size, firm growth leverage and profit are control variables. Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1
### Consumer Innovativeness Leading to Innovation Adoption

VARIABLES | (1) DRPTRP.FE | (2) DRPTRP.RE | (3) DRPTSP.RE | (4) DRPTSP.FE
--- | --- | --- | --- | ---
Bordsize | 0.0107 | 0.0991 | -0.0462 | -0.169
 | (0.146) | (0.132) | (0.173) | (0.195)
Bind | -0.1442* | -0.134*** | -0.146*** | -0.136***
 | (0.0950) | (0.0614) | (0.0121) | (0.0107)
Boardmet | -0.131* | -0.130* | 0.120 | 0.153
 | (0.0719) | (0.0667) | (0.0877) | (0.0959)
Ceodualty | 0.0157 | 0.0406 | -0.0488 | -0.0568
 | (0.0826) | (0.0375) | (0.0480) | (0.110)
Ceocompn | 0.00289 | 0.0406 | -0.0488 | -0.0568
 | (0.0826) | (0.0375) | (0.0480) | (0.110)
Assoctosp | 0.141 | 0.169* | -0.203 | -0.255*
 | (0.111) | (0.0952) | (0.124) | (0.148)
block20 | 0.0822* | 0.0406 | -0.0283 | -0.0167
 | (0.0467) | (0.0365) | (0.0476) | (0.0623)
block30 | -0.311*** | -0.213*** | 0.150** | 0.172*
 | (0.0665) | (0.0566) | (0.0740) | (0.0888)
Mos | 0.207** | 0.0933 | -0.0849 | 0.0177
 | (0.0825) | (0.0637) | (0.0830) | (0.110)
Instos | -0.000590 | 0.000885 | -0.0806 | -0.102
 | (0.0757) | (0.0719) | (0.0946) | (0.101)
Audit.Quality | -0.00427 | -0.0104 | -0.0106 | -0.00933
 | (0.0153) | (0.0147) | (0.0193) | (0.0204)
Bankloan | -0.00953 | -0.00862 | -0.0199* | -0.0169
 | (0.0105) | (0.00812) | (0.0106) | (0.0140)
Nobnk | -0.147** | -0.0775 | -0.126** | -0.191**
 | (0.0594) | (0.0483) | (0.0630) | (0.0793)
Fsiz | 0.00341 | 0.00276 | -0.00104 | -0.00111
 | (0.00576) | (0.00560) | (0.00738) | (0.00769)
Fgrowth | 0.00347 | 0.000439 | -0.00879 | -0.00849
 | (0.00591) | (0.00553) | (0.00728) | (0.00789)
Lev2 | 0.000857 | 0.00102 | 0.000807 | 0.00117
 | (0.00250) | (0.00248) | (0.00327) | (0.00334)
Npm | -0.00649 | -0.00403 | -0.00336 | -0.00348
 | (0.0146) | (0.0142) | (0.0187) | (0.0195)
Constant | 0.138 | 0.219 | 0.233 | 0.320
 | (0.190) | (0.223) | (0.288) | (0.253)
Firm | No | No | Yes | Yes
Year | No | No | Yes | Yes
Observations | 893 | 893 | 893 | 893
R-squared | 0.064 | | | 0.025
Number of sno | 159 | 159 | 159 | 159
References


Gibson, MS (2003). ‘Is corporate governance ineffective in emerging markets?’ The


