ASSOCIATION BETWEEN CORPORATE GOVERNANCE MECHANISMS AND RELATED PARTY TRANSACTONS IN MALAYSIAN PUBLIC LISTED FIRMS

AIRA ILLYANI BINTI ABD. AZIZ

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By

Aira Illyani Binti Abd. Aziz

KOLEJ PERNIAGAAN
(College of Business)
Universiti Utara Malaysia

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ABSTRACT

This paper examines the roles of corporate governance mechanisms in monitoring the management activity in engaging related party transactions in Malaysian public listed firms. The corporate governance mechanisms such as CEO duality, proportion of non executive directors in board of directors, directors ownership, proportion of non executive directors in audit committee and meeting frequency were used to measure whether corporate governance mechanisms are effective in deterring the management from doing earnings management through related party transactions. The result indicate that there is positively significant relationship between CEO duality and RPT. The findings also support the hypothesis where there is positive relationship between the non executive directors in BOD with RPT. But, the result indicate that there is no significant relationship between the director ownership with RPT. Moreover, from the result, it shows that the audit committee variables which are the non executive directors in audit committee and meeting frequency does not have a significant relationship with related party transactions.

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Abbreviations

AC	: Audit Committee
AICPA	: American Institute of Certified Public Accountant
BOD	: Board Of Director
BMSB	: Bursa Malaysia Sdn Bhd
BRPT	: Binary Related Party Transactions
CEO	: Chief Executive Officer
EBITDA	: Earnings Before Interest, Tax, Depreciation and Amortization
FRS	: Financial Reporting Standard
MASB	: Malaysian Accounting Standard Board
MCCG	: Malaysian Code of Corporate Governance
MTBV	: Market to Book Value
NEDs	: Non Executive Directors
RPT	: Related Party Transactions
UUM	: Universiti Utara Malaysia

CHAPTER ONE

1.0 INTRODUCTION

In 1997, the East Asian Financial Crisis saw the economies of Thailand, Indonesia, South Korea, Malaysia and Philippines severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies. In the early 2000s, the massive bankruptcies of Enron and WorldCom, as well as lesser corporate debacles, such as Adelphia Communications, AOL, Arthur Andersen, Global Crossing, Tyco, led to increased shareholder and governmental interest in corporate governance. These financial crisis indicate weak corporate governance practices of many firms such as the weak financial structure, lack of transparency, disclosure and accountability, existence of a complex system of family control firms, little or no effective laws to ensure that controlling shareholders and management treat small investors fairly and equitably, lack of transparency and ambiguity in the regulatory processes and weaknesses in the credit evaluation processes by the banks.

Although the weak corporate governance practices by these firms did not cause the financial crisis, but it certainly one of the factors that contributed to the economic crisis. Good corporate governance plays a vital role in underpinning the integrity and efficiency of financial markets. Poor corporate governance weakens a firm's potential and at worst can cover the way for financial difficulties and even fraud. If firms are well governed, they will usually outperform other firms and will be able to attract investors whose support can help to finance further growth.

Generally, an effective corporate governance mechanism on the management is crucial to ensure manager's action is in line with shareholder's interest. Conflict of interest between managers and shareholders becomes apparent when there is a separation between the people who own a firm and the people who manage the firm (Jensen & Meckling, 1976). In the present business structure, this separation is common among large listed firms because the owners appointed management which may have very minimal shareholding to run the day to day activities on behalf of the owners. In these firms, failure to monitor the management may lead to inefficient resource allocation and to some extent, earnings management and then followed by corporate scandals.

Related Party Transactions (RPT) is one of the recurring areas that have been highlighted in the corporate scandals. This is because of the complexity of the transactions between a firm and its own managers, directors, principal owners or affiliates. Because the transactions are with the firms insiders, related party transactions may open up venue and opportunities to expropriate firm resources. If the firm's management engage in the related party transactions to expropriate a firm's resources, then they may have the intend to manage the company earning for their own benefit.

1.1 Problem Statement

Theory suggests that there are two alternative views of related party transactions, where each have different implication to the earnings management. The first view is the conflict of interest view where related party transactions compromise management's agency responsibility to shareholders or a board of director's monitoring function. The conflict of interest view also portrays related party transactions as potentially harmful to the interests of the shareholders. American Institute of Certified Public Accountant (AICPA,2001) describes related party transactions as a mechanism used by major shareholders and management to overstate income and provide inaccurate financial results to market participants. Related party transactions would be more prevalence when a firm's corporate governance mechanism are weak, this will lead to earnings management.

The second view is that related party transactions realistically fulfill the underlying economic demands of a firm such as the needs for in-depth firm knowledge and expertise. Under this view, there is no motivation to manage earnings since the related party transactions need not to be obscured, so there would be no need to increase monitoring. As a result, there would be no association between related party transactions, strength of corporate governance mechanism and earnings management.

Kohlbeck and Mayhew (2004a) found a positive correlation between weak corporate governance and related party transactions, negative correlation between related party transactions and cash compensation of CEO and board of directors, positive correlation between stock option held by CEO and related party transactions, while no correlation exists between related party transactions and stock options held by board of directors and other officers. Jensen and Meckling (1976) portrays that the agency conflict between a manager and outside shareholders as the manager's tendency to expropriate the firm's resources for their own benefit. Thus, they represent the potential for the expropriation of the firm's resources. Gordon, Henry and Palia (2004) study the relationship between related party transactions and the extant literature's corporate governance mechanisms such as board characteristics, CEO pay-performance sensitivity, and outside monitors, they found that weaker corporate governance mechanisms are associated with more and higher dollar amounts of related party transactions. As a result, they provide support for the view of related party transactions as conflicts of interest between managers or board members and their shareholders.

This study aims to discuss the relationship of related party transactions, earnings management and corporate governance in public listed companies in Malaysia. This study is of interest due to cases of Enron, WorldCom and some other companies in the U.S and recently in Malaysia, which are Transmile and Sime Darby, where the stakeholders question the effectiveness of corporate governance mechanism on the management. In this study, the issue of earnings management practices using related party transactions is examined and how corporate governance mechanism such as board and audit committee can help to deter the management from earnings management practices.

1.2 Research Question

1) What is the extent of related party transactions disclosure in Malaysia?

2) Are corporate governance mechanism affects firms decisions to manage earnings through related party transactions?

1. 3 Objective of the study

1) To investigate the extent of related party transactions disclosure among public listed firms in Malaysia.

2) To examine whether the corporate governance mechanism such as CEO duality, directors ownership, proportion of non executive directors in Board of Directors (BOD), proportion of non executive directors in audit committee and meeting frequency is adequate to deter the management from earnings management practices.

1.4 Significant of the study

The study contribute to the literature in the following ways. Firstly, it contributes to the literature on the related party transactions of the companies in Malaysia. Particularly , it shed a new light upon the association between related party transactions and earnings management. Second, this study will provide insight into the monitoring the management decisions in engaging in the transactions which might lead to inefficient resources allocation, and consequently, financial misrepresentations. Lastly, this study adds to the literature review of corporate governance and sheds some insight on corporate governance mechanism which are board and audit committee roles in monitoring the related party transactions engaged by the company.

CHAPTER TWO

2.0 LITERATURE REVIEW

There are many studies on corporate governance, particularly on good corporate governance where it serves as an effective mechanism to alleviate the opportunistic behaviors of management, to improve a firm's reporting quality, and to increase firm value (Chan et al., 2009; Bhagat and Bolton, 2008). There are also studies that on how governance help in controlling the actions of the top management. For example, firm ownership and board structures, which represent a firm's governance style, have been used to help explain management's actions on corporate restructuring (Netter et al., 2009; Bauguess et al., 2009), dividend decisions (Brav et al., 2005), and the pricing of executive stock options (Chidambaran and Prabhala, 2003). There are also examples on how governance has controlled managers' opportunistic uses of discretionary accruals in a firm's financial statements (Chung et al., 2002; Park and Shin, 2004), inter-group borrowings (Berkman et al., 2009), and corporate fraud (Chen et al., 2006). Levine et al., (1997) stated that one neglected area of research is management's decision making on related-party sales, an area where these transaction are difficult to monitor and audit. By using related parties transaction, resources can be transferred between different stakeholders resulting in gains to some and losses to others.

Undeniably, related party transactions has the potential to distort incentives, benefit one set of investors or stakeholders over another, and give harm to the reputation of the firm. However, managers' or controlling shareholders' abilities to engage in related party transactions depends on a firm's corporate governance. Good corporate governance mechanisms, for instance, the characteristics of the board of directors and corporate ownership, should enhance the fairness among the different stakeholders in the business (Jensen, 2005; Matten and Crane, 2005). Donaldson and Preston (1995) suggest that independent directors should ensure that financial decisions are made in the best interests of all shareholders and should not result in earnings or cash flows that are biased toward the managers, controlling shareholders, or the minority shareholders. Furthermore, the governance mechanisms should ensure that a firm's long-term reputation is not diminished.

Agnes, Raymond and Michael (2010) find that firms with a board that has a high percentage of independent directors or a low percentage of "parent" directors (i.e., directors that are representatives of the parent companies of the listed firms) have a smaller magnitude of manipulated transfer prices through related party transactions. In addition, they find that firms that have different persons serving as the CEO and the chair of the board, and firms that have financial experts on their audit committees, are less likely to manage earnings through related party transactions such as transfer pricing manipulations transactions.

Jian and Wong (2010) shows evidence that Chinese listed firms use related sales to their controlling owners to prop up earnings. They find that the levels of related sales and operating profits from related sales are abnormally high when firms have incentives to manage earnings. Furthermore, they indicate that when there are incentives to meet earnings targets, related sales are used to reduce the effects of negative industry shocks on listed firms' earnings. Even though there are quite a lot of undependable evidence suggests that firms do use related party transactions to manage earnings, there has been very little research that investigates related party transactions as an earnings management tool.

2.1 Corporate Governance

Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2002) stated that Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interest of other stakeholders. From this statement we can see that corporate governance not only concern about shareholders, but as well as the stakeholders. The stakeholders include employee, customers, creditors, suppliers, regulators and the community at large.

The most well-known definition of corporate governance originates from the Cadbury Committee, which was set up in the UK in 1991 to raise standards in corporate governance. Corporate governance is the system by which companies are directed and controlled (Cadbury

Committee, 1992). While, according to Anglo-Saxon definition, Corporate Governance refers to the set of mechanisms designed to maintain an appropriate balance between the rights of shareholders and the need of Board and Management to direct and manage the corporation's affairs and ensure the company optimizes over time the returns to shareholders'.

From all of those corporate governance definitions, we can understand that corporate governance is a mechanism adopted by the firms to ensure integrity and ability of the board and management in taking strategic decisions as well as managing the affairs of the corporation. Corporate Governance has become very important element in the corporate sector. Kirti (2009) stated that it has emerged as a means of corporate excellence and driving force for attaining greater performance, maximizing the wealth of the stakeholder and corporate value. Yet, there is a little evidence that good governance can prevent further corporate failure or contribute to improved organizational effectiveness (Moxey, 2004).

2.2 Related Party Transactions (RPT)

FRS 124 stated that the related party transactions is a transactions between related parties, regardless of whether a price is charged while related parties as those who control or have interest that give significant influence over the firm. While, Companies Act 1965 states that a person shall be deemed to be connected with a director if he is a member of that director's family, or a body corporate which is associated with that director, or a trustee or a trust under which that director or a member of his family is a beneficiary, or a partner of that director or a partner of a person connected with that director. Bursa Malaysia Listing Requirements defines a related party transaction as a transaction entered into by a listed company or its subsidiary which involves the interest, direct or indirect, of a director, major shareholder or person connected with the director or major shareholder. Generally, different firms have different types of related party transactions. In Malaysian firms, there are various types of related party transactions such as sales of goods, purchase of goods, dividend, loans, compensation of key management, royalties and others.

Transactions between a firm and its own managers, directors, principal owners or affiliates are known as related party transactions (Gordon, Henry and Palia, 2004). The transactions, which are generally diverse and complex, represent a corporate governance challenge. One of the recurring areas of concern among corporate scandals is related party transactions. Regulators, market participants, and other corporate stakeholders usually viewed related party transactions as potential conflicts of interest that can compromise management responsibility or board of director's monitoring function. Related party transactions refers to the transferring of assets or liabilities between related parties, without regard to whether real payments are made. These transactions often cause a change in the net income of the parties involved. In theory, related party transactions are not necessarily evil. Even though they are not arm's-length transactions, related party transactions are not insider trading activities either.

2.3 Reporting Requirement for Related Party Transaction

Bursa Malaysia (2008) prescribes regulations governing related party transactions on the listing requirement in Part E where it requires a firm to make an immediate announcement to the Exchange of such transactions together with relevant information. It states that firms which undertake related party transactions that involve more than 5% of net tangible asset, are required to send a circular with relevant information to its shareholders and seek the approval from them at an Extraordinary General Meeting. Besides, the firm should also appoint an independent advisor, where one of their duties, is to comment as to whether the transaction is fair and reasonable so far as the shareholders are concerned and to advise minority shareholders on whether they should vote in favor of the transaction. If the transaction involves more than 25% of net tangible asset, firms must also appoint main adviser in addition to independent adviser.

Meanwhile, a director with any interest, direct or indirect must refrain from board deliberation and voting on the relevant resolution in respect to related party transactions. For recurrent related party transactions of a revenue or trading nature which necessary for the day-to-day operations of a firm such as supplies of materials, the Listing Requirements allow that a shareholders' approval for recurrent related party transactions be sought on a yearly basis (BMSB 2008). The aggregate value of transactions must be disclose in the annual report when the aggregate cost of the transactions is equal to or exceed RM1 million or 1% of net tangible asset, whichever is the lower.

There are also other provisions in the Companies Act (1965) regarding related party transactions. For example section 132E, 133 and 133A. Section 132E stated that the approval from shareholders in general meeting shall be obtain before a transaction of substantial value involving directors can be carried out. Besides that, the Act also states that the asset is considered to be in substantial value if its value is not less than RM10,000 but exceeds RM250,000 or 10% of the company's asset value. While, Section 133 prohibits a company from giving a loan or providing a security for a loan granted to its director and the director of its related company, *i.e.* its holding company, its subsidiary or the subsidiary of its holding company. Section 133A prohibits the company from giving a loan or providing a security for a loan granted to a person connected with its director or the director of its holding company.

In Malaysia, there are rules on Related Party Disclosures which is issued by the MASB. These rules include the requirement on the disclosure of related party transactions. FRS 124 requires that a firm to disclose the nature of related party transactions, which include at least, the amount of the transactions, the amount of outstanding balances, provision for doubtful debts related to the amount of outstanding balances, and the expense recognized during the period in respect of bad or doubtful debts due to related parties. A more comprehensive analysis of related party transactions can be made when the disclosures are made separately for each category of related party. Moreover, it is compulsory for a firms to disclose the relationships between firms and related parties so that financial statement users could form a view about the effects of related party relationships on a firm.

2.4 Earnings Management Incentive

There are many definition regarding earnings management. Schipper (1989) defines earnings management as "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain". From the definition, it is understood that earnings are manipulated to the extent where the accounting figure can facilitate managers meet some of their personal interest (Patten & Trompeter, 2003). Loomis (1999) found that managers may manage earnings to conceal the true financial situation of a firm and relevant information that investors should know. In view of the fact that the separation of managers and owners creates an opportunity for the management to provide misleading information to the shareholders, this will increase the agency costs of the firm. For example, the cost of additional monitoring and the cost of using the information that would result in inappropriate decisions (Norhashimah *et* al., 2008).

There are two conflicting argument on earnings managements where one side believe that earnings management practices with the intention to mislead users' perception are considered unethical even though no accounting standards are violated. While, on the other hand, some believe that earnings management that were practiced by firms is for the benefit of their investors. Financial reporting can increase firm value if information is reliable and available on time (Healy and Wahlen, 1999). As a result, approved accounting standards should provide the managers, on how to signal private information on firms' performance to the market. For example, in applying their own assumptions based on general principles described in the standards. Hence, by having a two completely conflicting arguments, it is not appropriate to control managerial accounting choices by virtue of rule-based standards because it would limit the flow of private information to the market. Thus, the choice of accounting policy and estimation has to be monitored. One of the ways to monitor the earnings management practice is through corporate governance mechanisms.

CHAPTER THREE

3.0 HYPOTHESES DEVELOPMENT

3.1 CEO Duality and Related Party Transactions

Another corporate governance issue that has given rise to concern is CEO duality or the 'dominant personality' phenomenon, where the CEO is also the chairman of the board. Separation of CEO and Chairman will provide essential checks and balances over management performance (Blackburn,1994). Agnes, Raymond and Michael (2010) finds that firms that have different persons serving as the CEO and the chair of the board, and firms that have financial experts on their audit committees, are less likely to manage earnings through transfer pricing manipulations. Before this, role duality is common in Malaysian companies, but the Malaysian Code of Corporate Governance (MCCG) recommends that companies should separate the two roles to ensure proper checks and balances on the top management of the corporation.

People who have the managerial expertise are employed to run the business and have a vested interest in controlling the company. There are possibilities that managers may run the business to maximize their own interests rather than maximizing the owners' wealth. It may be essential to provide managers with incentives in order to align their interests with the owners. In order to reduce agency problem, a firm may incur additional costs for independent monitoring board to monitor the management activities. Agency theorists argue that the roles of CEO and chairperson should be separated, otherwise, a single person holding both roles will dominate the board. Jensen (1993) stated that combining the roles of CEO and chairperson is generally a sign of a dominant CEO and could render the board ineffective in monitoring managerial opportunism. As a result, less independent directors will be appointed to the board.

Higgs (2003) recommends separating the roles of CEO and Chairman, which avoids concentration of authority and power in one individual and differentiates leadership on the board from running of the business. Generally, CEO is responsible for executing the company's policies and running the company, while the chairperson of the board is responsible for running the board and monitoring and evaluating managerial activities. Besides, the board is also responsible for overseeing the process of hiring, firing, evaluating, and compensating the CEO, and thus the chairperson should preferably not be the same person whose performance is being assessed, or else, one is self-evaluating (Jensen, 1993). Consequently, CEOs would therefore gain much power to further their own interests rather than the interests of shareholders (Weisbach, 1988).

Chen et al. (2005) indicate that family-controlled firms are more likely to have a CEO duality board structure because it provides opportunities for the controlling family members to obtain private benefits that are not shared by minority shareholders. For example, many companies in Malaysian are family controlled and group affiliated, and thus the possibility of expropriation of the minority shareholders by the controlling family is high. In these companies, controlling family members usually hold the titles of CEO and/or chairperson (La Porta et al., 1999). Thus, there are possibilities that CEO duality in the firms provides greater opportunities for management and expropriation of minority shareholders.

Gordon, Henry and Palia (2004) stated that while recent scandals highlight extreme examples of potential abuses of transactions with executives and board members, the view that related party transactions represent a conflict of interest is consistent with agency issues. Jensen and Meckling (1976) characterize the agency conflict between a manager and outside shareholders as the manager's tendency to appropriate the firm's resources for personal consumption, similar to perquisites. As a result, they represent the potential for the appropriation of the firm's resources. Therefore, the hypothesis is stated as below :

H1 : There is significant positive relationship between CEO duality and RPT.

3.2 Proportion of Non Executive Directors in BOD and Related Party Transactions

Corporate boards play an important role in ratifying and monitoring important decisions (Fama and Jensen, 1983). They play a particularly important role with regard to the issue of related parties transactions, as most of the related parties transactions need to be approved in the board meetings (Cheung et al., 2006). According to agency theory, outside directors perform better in monitoring managerial activities, whilst a higher proportion of outside directors on the board augments its monitoring effectiveness. The issue of monitoring becomes even more important when non-executive directors engage in related party transactions. Fama and Jensen (1983) stated that the optimal board composition should include both inside (executive) and outside (non-executive) board members. The inside board members bring in-depth knowledge while outside members bring independence and monitoring skills. Bushman et al. (2004) also believe that the industry-specific expertise of the outside director as beneficial to the firm and its board.

The MCCG recommends that firms should adopt good governance practice by having a balanced board composed of at least one-third NEDs to monitor management. However, boards dominated by NEDs who lack real independence and awareness of their responsibilities, and who do not have the appropriate qualifications and experience, may be harmful to firms. Millstein and MacAvoy (1998) found US corporations with a higher proportion of active independent boards perform much better than those with passive, non independent boards. Bushman et al. (2004) proposed that the greater the percentage of insiders on board, the less independent the board is. The monitoring ability of the board is then lessened due to lack of independence. Directors in the firms should ensure that financial decisions are made in the best interests of all shareholders.

For instance, a non-executive director possesses an in-depth knowledge of firm-specific activities as well as an expertise that the company demands such as legal expertise. Then it could be more effective and more cost efficient for the company to engage with related party to provide the service than an outsider. Because the non-executive director possesses an in-depth knowledge of the firm, information asymmetries are reduced and contracting enhanced. Many companies disclose that their contracts with related parties have been made on terms at least as favorable as with unrelated parties. Therefore, under the efficient transactions view, a firm engaging in related party transactions would incur no conflicts of interest and no increased agency or monitoring costs. Undeniably, monitoring benefits could arise from greater trust in dealing with family members or longer-term relationships. If a firm undertakes related party transactions which enhance or at least do not harm the economic interests of the shareholders, there should be no negative impact on the firm other than the increased costs of reporting complexity. Consistent with the view that related party transactions do not harm the interests of shareholders, arguments also have been made that the amount of the transactions is small to the related parties and not material to companies.

It has been recommended that boards dominated by outsiders or non-executive directors (NEDs) may help to alleviate the agency problem by monitoring and controlling the opportunistic behaviour of management (Jensen and Meckling, 1976). Moreover, by having non executive directors, it can ensure that managers are not the sole evaluators of their own performance (Baysinger and Hoskisson, 1990). Pearce and Zahra (1992) believe that boards dominated by NEDs may influence the quality of directors' deliberations and decisions and provide strategic direction and improvement in performance. By having NEDs in the companies, it is believe that it might provide additional windows on the world due to their expertise, prestige and contacts. Through their expertise and experience, NEDs could help the firms in making decision whether to engage in the related party transactions or not. Therefore, the hypothesis is stated as below :

H2: There is significant negative relationship between proportion of NEDs in BOD and RPT.

3.3 Director Ownership and Related Party Transactions

Palenzuela (2003) stated that director ownership may become an important feature in influencing the effectiveness of monitoring role in the financial accounting process. Whilst, according to agency theory, the interest of the management and the shareholders will starts to converge if the management also have a share of equity ownership in a firm. Some studies present contradictory result on the relationship between director ownership and the effectiveness of financial reporting monitoring. Mohd Saleh *et al.* (2005) stated that director ownership is negatively related with earnings management. While, Warfield (2005) study show that earnings management can be positively related with director ownership. According to the entrenchment hypothesis, when the directors' equity ownership is highly significant, primarily among the executive directors, more opportunities for them to make decisions that give advantage to themselves at the price of other stakeholders. Moreover, directors could use the related party transactions to overstate income and provide inaccurate financial results to market participants Hence, if the director equity ownership is high, it would lower the convergence of interests.

Kim and Yi (2005) provide evidence that earnings management can be positively related with management ownership. Constant with Claessens *et al.* (2000) indicate that ownership structure in Malaysian firms is highly concentrated, this effect could dictate if the director equity ownership is significant. Thus, according to the prior research there is a significantly relationship between earnings management and director ownership, where the directors would use related party transaction to do earnings management. Therefore, the hypothesis is stated as below :

H3 : There is significant positive relationship between director ownership and RPT.

3.4 Proportion of Non Executive Directors in AC and Related Party Transactions

Generally, composition of an audit committee members depends on the ratio of non-executive and executive directors. Audit committees with a higher composition of non-executive directors are seen more independent than those with more executive directors. An audit committee's effectiveness is rooted in its independence and expertise of its members. There is proof that executive directors would control the decision-making process of the company's management, resulting in less objective decisions. The presence of non-executive directors as the majority members of the audit committee would enhance the independence of the committee. Previous studies show that non-executive directors are capable to provide independent views to the top management for consideration because of their potential to act more independently than executive directors (Vinten and Lee, 1993). This argument is consistent with the principles specified in the Code of Best Practice of Corporate Governance. The code states that the board should establish an audit committee comprising at least three members, a majority of whom are independent and all members of the audit committee should be non-executive directors.

H4 : There is significant negative relationship between proportion of NEDs in AC and RPT.

3.5 Meeting Frequency and Related Party Transactions

Prior studies uses frequency of meetings to measure audit committee activeness (McMullen and Raghunandan, 1996; Collier and Gregory, 1999). Their findings propose that an audit committee that meets more frequently provides a more effective oversight and monitoring mechanism on financial activities, which include the preparation and reporting of the company financial information. This evidence is align with the guidelines by the Best Practice Code of Corporate Governance in Malaysia. These guidelines require audit committees to meet not less than four times a year. A properly planned meeting schedule would ensure the timeliness of audit committee decisions and those decision are made for the best interest of the firms. By having an effective audit committee in a firm, it could deter the management from manipulating the earnings through related party transactions. Therefore, the hypothesis is stated as below :

H5 : There is significant negative relationship between meeting frequency and RPT.

CHAPTER FOUR

4.0 RESEARCH METHODOLOGY

4.1 Data Collection

The population of the study is all the public listed firms that were listed on Bursa Malaysia. A sample size of 50 firms are selected from consumer products industry on the Bursa Malaysia listed firms during the year 2008. The consumer products industry were selected as the sample in this study because the market dynamics for the consumer products industry are changing rapidly and drastically. Thus, the possibility of having a high amount of related party transactions triggering red flags in a firm. Generally, related parties transaction are perceived as proxy of expropriation of minority interest. In this study, the total amount of RPTs of all 50 firms in 2008 is RM 4,665,195,000.

The sampling technique of simple random sampling will be used, which is to ensures each element in the population will have an equal chance of being included in the sample. All banks, insurance and unit trusts companies were excluded because of different statutory requirements. In addition, their final accounts are also differently structured and therefore accounting performance comparisons are not straight forward. Data on board of directors, Shareholders and Companies Corporate Governance variables will be collect from annual report available on Bursa Malaysia's Website (www.bursamalaysia.com).

4.2 Variable Measurement

4.2.1 Measurement for Dependent Variable

Related Party Transactions is the dependent variable in this study. The RPT were classified into six main types of transactions that were selected from many types of transactions engage by the company. The six types of transactions are sale of goods, purchase of goods, dividend, royalties, compensation of key management and others. This study follow Saadiah (2009) in measuring related party transactions. In addition, this study collected the monetary value of each transaction and calculated the total value of the transactions for each firm in the sample. The data was grouped into two categories, which are high RPT and low RPT. High RPT category consists of firms with total value of related party transactions equal to or more than 10% of the firms' total sales and coded as 1. Low RPT category consists of firms with total value of related party transactions less than 10% of the firms' total sales and coded as 0.

4.2.2 Measurement for Independent Variables

There are five independent variables in this study. They are role duality, director ownership, proportion of non executive directors in BOD, proportion of non executive directors in AC and meeting frequency. Table 1 provided the operationalisation of variables.

4.2.3 Measurement for Control Variables

The choices of control variables used in this study are based on prior study. In this study, there are three control variables. The three control variable are leverage, earnings before interest, tax, depreciation and amortization (EBITDA) and market to book value (MTBV). Table 1 provided the operationalisation of variables.

Table 1 : Operationalisation of variables

Operationalisation of variables	
Dependent variable Related Party Transactions (RPT) Binary RPT (BRPT)	Following Saadiah (2009), a cut-off point of 10% of total sales was used to categorize the data of RPT. Percentage of related party transactions from the total sales Coded 0 if the percentage is less than 10%, 1 if the percentage is more than 10%
Independent variables Directors ownership (DIR)	Percentage of director shares from the total of firm shares

CEO Duality (DUAL)	Coded 1 if the firm has CEO who is also serving as the chairman, 0 otherwise
Non Executive Directors on BOD (NEDB)	Percentage of non-executive directors in Board of Directors to the total members
Non Executive Directors Audit Committee (NEDAC)	Percentage of non-executive directors audit committee to the total members
Meeting Frequency (MFRE)	Frequency of audit committee meeting in the financial year
Control Variables	
Leverage (LEV)	Percentage of total liabilities to total assets
EBITDA (EBIT)	Percentage of EBITDA to total assets
Market to Book Value (MTBV)	Market to book value of the firm

4.3 Results and Discussion

4.3.1 Descriptive statistics

The descriptive statistics for both dependent and independent variables are provided in Table 2 and Table 3.

The average RPTs in this sample for the year 2008 is 17.13% of total sales. The maximum percentage of RPTs in 2008 is 79.59. The results show that Emivest Bhd is using related party in most of its transactions for the company. On the other hand, the minimum percentage of RPTs is less than 1% where this data is obtained from Latitude Tree Holdings Bhd. The average result of director ownership is around 35%. The maximum percentage for director ownership is quiet high which is around 75% whereas the minimum is 0%. Table 2 shows that only around 20% of the company have CEO duality in the company where the CEO is also the chairman of the company. Most of the company had separated the role of the two positions among different individuals. The result in this study shows that the recommendation for the separation of CEO and the chairman contained in the Malaysian Code of Corporate Governance (MCCG 2007) had been well complied by a great majority of Malaysian firms.

Meanwhile, the result also shows that at average, around 61.74% of the companies have complied with the requirement of the Code on Corporate Governance that required the proportion of independence non executive directors, should be at least one third (1/3) from the total number of directors. Further, table 2 also shows that 86% of the firms have non executive directors in their audit committee board. This prove that all of the firms in the sample are following the recommendation on audit committees in the MCCG 2007. The mean leverage for the sample is 43.40% which indicate that the liabilities of the companies in the sample are quiet high. Whilst, market to book value(MTBV) in the sample ranges between -0.98 and 31.24. Thus, the mean firm MTBV is 1.63. The highest companies that have MTBV is British American Tobacco (M) Bhd which is 31.24.

Table 2 : Descriptive Statistics for the year 2008

Variables	Mean	Minimum	Maximum	Standard Deviation
RPT08	0. 1713	0.0042	0.7959	0.1699
BRPT08	0.5800	0.0000	1.0000	0.4986
DIR08	0.3562	0.0000	0.7470	0.2218
DUAL08	0.2200	0.0000	1.0000	0.4184
NEDB08	0.6174	0.3333	0.9091	0.1602
NEDAC08	0.8610	0.5000	1.0000	0.1631
MFRE08	4.820	4.0000	8.0000	0.9189
LEV08	0.4338	0.0729	1.0863	0.2002
EBIT08	0.1137	0.0916	0.8027	0.1264
MTBV08	1.637	0.9800	31.3400	4.6312

4.3.2 Correlation

Table 3 presents the correlations results among the variables in the test models. The table indicate that the related party transaction for 2008 is negatively related to director ownership, meeting frequency and leverage. While, it is positively related to CEO duality, non executive directors in BOD, non executive directors in AC and EBITDA.

Table 3 : Correlation between the variables in the year 2008

Variables	RPT08	DIR08	DUAL08	NEDB08	NEDAC08	MFRE08	LEV08	EBIT08
RPT08	1.0000							
DIR08	-0.1417	1.0000						
DUAL08	0.2966	0.0397	1.0000					
NEDB08	0.1531	-0.2293	-0.0310	1.0000				
NEDAC08	0.0438	-0.3801	-0.0761	0.2195	1.0000			
MFRE08	-0.1203	0.1007	-0.1072	-0.1102	-0.2339	1.0000		
LEV08	-0.0317	-0.2252	-0.0696	-0.0646	0.0919	0.2154	1.0000	
EBIT08	0.0608	-0.2429	-0.0315	0.0631	0.1370	-0.1869	0.0615	1.0000

4.3.3 Linear Regression

Table 4 presents the linear regression for the year 2008. From the table 4, we can see that only CEO duality is significant with RPT. The coefficient for CEO duality is positive, as expected, and is significant. This result supports the hypothesis of the positive association between CEO duality and RPT.

Table 4 : Linear Regression for the year 2008

RPT	Coefficient	Standard Error	T	P-Value (one-tailed test)
DIR08	-0.095907	0.135576	-0.71	0.242
DUAL08	0.120632	0.077107	1.56	0.063
NEDB08	0.137854	0.137443	1.00	0.161
NEDAC08	-0.026462	0.159846	-0.17	0.435
MFRE08	-0.010924	0.021264	-0.51	0.305
LEV08	-0.014665	0.144415	-0.10	0.460
EBIT08	0.033728	0.148388	0.23	0.411
CONS	0.171787	0.237838	0.72	0.237

4.3.4 Variance Inflation Factors

Table 5 : Variance Inflation Factors 2008

Variable	VIF	1/VIF
DIR08	1.32	0.759306
NEDAC08	1.26	0.791979
MFRE08	1.18	0.845626
LEV08	1.14	0.874122
EBIT08	1.10	0.910421
NEDB08	1.10	0.911047
DUAL08	1.03	0.974465
Mean VIF	1.16	

The Variance Inflation Factors(VIF) in 2008 is not more than 10. This indicates that there is no multicollinearity problem with the variable.

4.3.5 Probit Regression and Marginal effects after probit regression

Probit regression were used in this study because the dependent variable is dichotomous (0 or 1). Table 6 indicate the result of probit regression for the year 2008. From the table, we can see that there is significant relationship between BRPT and CEO duality. The result supports the hypothesis that there is positively significant relationship between CEO Duality and RPT. Besides, the table also shows that there is significant positive relationship between BRPT with non executive directors in BOD and EBITDA.

Table 7 present the result of the marginal effects after probit regression in 2008. From the table, we can see that 1% increase in director ownership will decrease 7.59% in RPT. The result is contrary with the hypothesis, this might be because of the limited numbers of sample size used in the study. Thus, it could not be a representative as a whole population. While in CEO duality, 1% increase in CEO duality will increase 15.93% of RPT. The result support the hypothesis where if there is CEO duality in a firms, this will increase the probability of having related party transactions in a firms. Further, the table shows that an increase in 1% in non executive directors in BOD will increase 42.84% in RPT. The result is contrary with the hypothesis where the hypothesis expect there is negative relationship between the non executive directors in BOD with RPT. Although the result is contrary with the hypothesis but the result is consistent with the efficient transactions view, where if a firm undertakes related party transactions which enhance or at least do not harm the economic interests of the shareholders, there should be no negative impact on the firm.

While, for the audit committee mechanism which are the proportion of non executive directors in Audit committee and the meeting frequency show there are negative relationship with the RRT. An increase of 1% in NEDs audit committee will decrease 25.93% in RPT. Whereas, an increase of 1% in meeting frequency will decrease 1.10% in RPT. The table also indicate that an increase of 1% in EBITDA, will increase 59.83% in RPT.

Table 6 : Probit Regression for the year 2008

BRPT08	Coefficient	Standard Error	z	P-Value (one-tailed test)
DIR08	-0.393382	0.903097	-0.44	0.332
DUAL08	0.937886	0.478719	1.96	0.025
NEDB08	2.218937	1.338934	1.66	0.049
NEDAC08	-1.34259	1.415457	-0.95	0.172
MFRE08	-0.057423	0.21153	-0.27	0.393
LEV08	-0.62708	1.187611	-0.53	0.299
EBIT08	3.098782	2.014932	1.54	0.062
CONS	0.170944	2.100682	0.08	0.468

Table 7 : Marginal effects after probit for the year 2008

Variable	dy/dx	Standard Error	z	P-Value (one-tailed test)
DIR08	-0.075964	0.34851	-0.44	0.332
DUAL08	0.159351	0.13308	2.39	0.008
NEDB08	0.428484	0.51729	1.66	0.049
NEDAC08	-0.259258	0.53984	-0.96	0.169
MFRE08	-0.011089	0.08156	-0.27	0.393
LEV08	-0.121091	0.46035	-0.53	0.299
EBIT08	0.598385	0.77514	1.54	0.062

CHAPTER FIVE

5.0 CONCLUSION

The purpose of the study is to investigate the extent of related party transactions disclosure among public listed firms in Malaysia. Moreover, this study also attempts to examine whether the corporate governance mechanism such as CEO duality, directors ownership, proportion of non executive directors in Board of Directors (BOD), proportion of non executive directors in audit committee and meeting frequency is adequate to deter the management from earnings management practices. In this study, the issue of management using related party transactions to manage earnings is discuss and how corporate governance mechanism such as board and audit committee can help to deter the management from earnings management practices.

One of the hypothesis in the study is there is significantly positive relationship between director ownership and RPT. According to the prior research there is a significantly relationship between earnings management and director ownership, where the directors would use related party transaction to do earnings management. On the contrary, this study do not find that director ownership positively influence the value of RPT possibly because of the limited sample size. Thus, the result is not representative for the whole population. In addition, the findings of the study indicate that there is positively significant relationship between CEO duality and RPT. The result support the hypothesis where if there is CEO duality in a firm, there will be an increase the probability of having related party transactions in a firms. Thus, they represent the potential for the appropriation of the firm's resources through related party transactions.

While, for the third hypothesis, the result is contrary with the hypothesis where the hypothesis expect there is negative relationship between the non executive directors in BOD with RPT. Although the result is contrary with the hypothesis but the result is consistent with the efficient transactions view, where if a firm undertakes related party transactions which enhance or at least do not harm the economic interests of the shareholders, there should be no negative impact on the firm.

From the result, it shows that the audit committee variables which are the non executive directors in audit committee and meeting frequency does not have a significant relationship with related party transactions. This means that the Audit Committee mechanism does not influence related party transactions. Although previous study found that by having an effective audit committee in a firm, it could deter the management from manipulating the earnings through related party transactions. The result does not support the hypothesis. This might be because of the small sample size were used and the study only focus on one industry.

There are a few limitations identified in this study. Firstly, the sample only consists of 50 firms from the whole population of the listed firms in the Bursa Malaysia. Therefore, this small sample size is not sufficient and should not be use to represent the population as a whole. Secondly, the sample were selected from one industry only which is the consumer products industry. By using only one industry, it is not sufficient to support the hypothesis that have been made. Further study is needed to explore the significant of which types of related party transaction that were used as a proxy to expropriate the minority interest or to do earnings management.

Variables	Expected Relationship	Results
H1 CEO Duality	+ve , ↑ DUAL ↑ RPT	Significantly Positive
H2 NEDs on BOD	-ve , ↑ NEDB ↓ RPT	Significantly Positive
H3 Directors Ownership	+ve , ↑ DIR ↑ RPT	Not Significant
H4 NEDs on AC	-ve , ↑ NEDAC ↓ RPT	Not Significant
H5 Meeting Frequency	-ve , ↑ MFRE ↓ RPT	Not Significant

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