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Separating abusive from efficient related-party transactions: evidence from India

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Abstract

Purpose – The aim of this study is to understand a family firm's choice of related-party transaction (RPT) types and analyze their value impacts to separate the abusive from benign RPTs.

Design/methodology/approach – It uses a 10-year panel of BSE-listed 378 family (and 200 non-family) firms. The fixed effects, logit and difference-in-difference (DID) models help examine value effects, propensity and persistence of harmful RPTs.

Findings – Loans/guarantees (irrespective of counterparties) destroy firm value. Capital asset RPTs decrease the firm value but enhance value when undertaken with holding parties. Operating RPTs increase firm value and profitability. They improve asset utilization and reduce discretionary expenses (especially when made with controlled entities). Family firms have larger loans/guarantees and capital asset volumes but have smaller operating RPTs than non-family firms. They are less likely to undertake loans/guarantees (and even operating RPTs) and more capital RPTs vis-à-vis non-family firms. Family firms persist with dubious loans/guarantees but hold back beneficial operating RPTs, despite RPTs being in investor cross-hairs amid the Satyam scam.

Research limitations/implications – Rent extractability and counterparty incentives supplement each other. (1) The higher extractability of related-party loans and guarantees (RPLGs) dominates the lower extraction incentives of controlled parties. (2) Holding parties' bringing assets, providing a growth engine and adding value dominate their higher extraction incentives (3) The big gains to the operational efficiency come from operating RPTs with controlled parties, generally operating companies in the family house. (4) Dubious RPTs seem more integral to family firms' choices than non-family firms. (5) Counterparty incentives behind the divergent use of RPTs deserve more research attention. Future studies can give more attention to how family characteristics affect divergent motives behind RPTs.

Practical implications – First, the study does not single out family firms for dubious use of all RPTs. Second, investors, auditors or creditors must pay close attention to RPLGs as a special expropriation mechanism. Third, operating RPTs (and capital RPTs with holding parties) benefit family firms. However, solid procedural safeguards are necessary. Overall, results may help clarify the dilemma Indian regulators face in balancing the abusive and business sides of RPTs.

Originality/value – The study fills the gap by arguing why some RPTs may be dubious or benign and then shows how RPTs' misuse depends on counterparty types. It shows operating RPTs enhance operating efficiencies on several dimensions and that benefits may vary with counterparty types. It also presents the first evidence that family firms favor dubious RPTs more and efficient RPTs less than non-family firms.

Keywords India, Family firms, Corporate governance, Tunneling, Related party transactions

Paper type Research paper

1. Introduction

According to agency theory, the conflict-of-interest hypothesis views related party transactions (RPTs) as the tombstone of shady governance practices to expropriate value (OECD, 2014). Hidden motives and verification problems of RPTs allow firms to mislead with impunity in markets like India, characterized by the prevalence of family firms and poor investor protection. Recent corporate scams in India [1] have brought RPTs into the cross-hairs, inviting calls for a ban on RPTs. Indian Ministry of Finance (2012) regards related party

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