CORPORATE GOVERNANCE AND RELATED PARTY TRANSACTIONS RESEARCH: AN ASSESSMENT OF THEORIES AND METHODOLOGIES

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Abstract

This paper critically evaluates the paradigm, theory, and methodology that dominate research on related party transactions (RPTs). RPTs have been debated in the literature whether they are a facet of conflict of interest between major and minor shareholders or they are normal efficient transactions that help the firms to achieve asset utilization. Literature has been widely interested in studying the association between corporate governance and RPTs especially that according to the agency theory it is assumed that corporate governance as a monitoring tool should impede the negative consequences of RPTs and ensure they are conducted to achieve better asset utilization.

Keywords: Corporate Governance, Party Transactions, RPT

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1. Introduction

Prior research on related party transactions shows significant evidence that a lot of problems are arising from the related party transactions and the disclosures of such transactions. The corporate scandals have brought attention to the potential for accounting manipulations associated with related party transactions which have led to a decline in perceived earnings quality (Ge et al., 2010). Moreover, related party transactions appeared to be causing major value damaging effects for firms and shareholders as well.

Djankov et al., 2008 mentioned that related party transactions may provide direct opportunities for related parties to extract cash from listed companies through tunneling activities. On the other hand they can also be used to prop up under performing firms (Friedman et al., 2003). Consequently, related party transactions in many cases do affect some economies negatively, such as its impact on stock market and stock prices as prior research shows (Cheung et al., 2009).

On the other hand, the contrary view perceives related party transactions as a widespread, long-standing form of business activity that can have positive effects. Where related party transactions are implemented appropriately, listed companies can make use of them to reduce transaction costs and achieve more efficient asset utilization (Chein and Hsu 2010). Gordon et al 2004 findings show strong support for the conflict of interest hypothesis which is relevant to the agency theory.

The literature for related party transactions focused mainly on linking the related party transactions to inflated earnings, decline of minority shareholder wealth, decline in firm value, low firm performance and negative excess returns (Berkman et al., 2009, Cheung et al., 2006 Cheung et al., 2009, Ge et al., 2010, Lei& Song 2011, Chen et al., 2009, Gordon & Henry 2005, and Chalevas 2009).

The paradigm used for previous studies on related party transactions was mainly a positivist paradigm, which relies mainly on a quantitative approach. Studying related party transactions from the positivist position implies that the researcher would normally use a highly structured methodology and emphasis will be on quantifiable observations or measures (Lee and Lings 2008).

This paper will critically evaluate the paradigm, theory, and methodology that dominate research on related party transactions. The paper will proceed as follows; section 2 will be devoted to discussing the literature on related party transactions and express their relationship with the corporate governance based on the Agency Theory assumptions. Section 3 will evaluate the methodological research designs for related party transactions including a comparison between qualitative and quantitative research designs for this specific field of research. Section 4 will propose an alternative methodology that might be appropriate for the research problem. Finally, section 5 will conclude the paper.

2. Related Party Transactions and the Agency Theory

Related party transactions have been defined in numerous studies. Chein & Hsu 2010, Henry et al., 2007 , Cheung et al., 2006, Gordon & Henry 2005, Gordon et al., 2004, and other studies defined related party transactions and studied their association with corporate governance, fraudulent financial reporting, earnings management, and many other phenomena.

Related party transaction is defined as a transfer of resources or obligations between related parties, whether this transfer is expressed in monetary terms or not. A related party is in essence is a party that can control or have influence on an entity or a party that is controlled or owned by the entity specified (Chien & Hsu 2010).

Management opportunism which is one of the principal-agent conflicts discussed within the context of the agency theory which is considered a key driver in the misappropriation of assets and misleading financial reporting in the recent frauds at Enron, HealthSouth, and others. In many of these frauds management already used related party transactions both to enrich themselves and generate misleading financial statements (Kohlbeck & Mayhew 2010).

Moreover, prior studies state that good corporate governance is an effective tool to lessen the opportunistic behavior of management, to improve a company's reporting quality, and to increase the value of a firm and move the related party transactions form the conflict of interest to efficient transactions (Denis & McConnell, 2003; Bhagat & Bolton, 2008, Gordon and Henry 2005, Chien and Hsu 2010, and AbdulWahab et al., 2010).

Thus, the presence of high quality corporate governance activities can mitigate the negative effect of related party transactions and thus enhance firm performance (AbdulWahab et al., 2010, Gordon et al., 2004, and Gordon and Henry 2005).

In nearly all the studies addressing related party transactions a deductive approach was used to address the research questions. In the deductive approach on the basis of **what** is known about related party transactions, deduces a hypothesis that raises an expectation of what impact related party transactions might have on firm performance. Such hypothesis must be then subjected to empirical scrutiny (Bryman and Bell 2007). Most of the research questions seeking more knowledge about related party transactions, its impact on other dependent variables, and their association with corporate governance were "What" or "How". This type of questions is normally associated with a deductive approach attempting to quantify or test the existence of a certain phenomena, predict its occurrence (Collis and Hussey 2003). On the contrary research questions starting with "Why" for example, might be aiming to understand or interpret why related party transactions have negative impact on firm performance. The purpose here would be to obtain some knowledge about what is going on (Saunders et al., 2007), or in other words **why** is a certain behavior or phenomena taking place.

Thus, the later type of research questions is normally answered by following an inductive approach. This use of inductive approach in studying related party transactions to the most possible best level of knowledge is not significantly taking place so far. This lack of qualitative research might be due to the newness of the research domain under question, however there is a need to address this domain using qualitative approach that goes beyond the quantification or the existence of related party transactions, or its impact on the firms practicing it to understanding the motives and reasons for their existence, why could they benefit or negatively affect the firm, and how can corporate governance eliminate or minimize the unhealthy effects that related party transactions might have on the firm's financial health.

The agency theory is the most relevant theory to related party transactions, and it is "the overwhelmingly dominant theoretical perspective applied in corporate governance studies (Daily et al., 2003). As previously mentioned there are two contrasting views in the literature that debated the nature and the impact that related party transactions have on firm's performance and shareholder's wealth as well. The conflict of interest problem associated with related party transactions are expected to be controlled through undertaking sound corporate governance activities that could enhance the overall quality of corporate governance. In the context of corporations and issues of corporate control, agency theory views corporate governance activities as a crucial monitoring device to try to assure that any problems that might float on the surface by the principal-agent relationship are minimized (Mallin 2010).

Hence, when a positivist stance is applied the researchers try to **test** whether the assumed negative relationship between related party transactions and firm value and/or performance exist or not. Thus they usually deduct a hypothesis based on a theoretical underpinning, then attempt to test the theory in a defined context.

3. Methodology and research designs

A methodology is the overall approach followed in the research process; theoretical underpinning, data collection and analysis (Collis and Hussey, 2003). As previously discussed, most of the research previously performed to tackle research questions relevant to related party transactions, its impact on firm performance, and the effect of corporate governance on this impact were undertaken from a positivist stance. This position enables quantifying, determining, and measuring the presence of the latter mentioned variables and the inter-relation between them. This approach makes that quantitative data naturally more associated with such research domain.

The deductive approach is used and theories are quantitatively tested within this approach. Theories that are tested quantitatively are mature theories; the aim of data collected is to have focused measures whether the extent or amount of certain phenomena is meaningful (Edmonson and McManus, 2007). Since the agency theory as previously mentioned is the most relevant theory to related party transactions, and the most dominant theory in the corporate governance literature, therefore it has been tested mainly using quantitative research. Also, researchers interested in studying related party transactions tended to measure related party transactions using quantitative measures. The measure most commonly used was the monetary value of the related party transactions as a percentage of the firm's total assets at year end. The relationship between related party transactions and other variables like corporate governance, and firm performance/value was examined using correlations and regression analyses.

When we compare quantitative designs to qualitative designs it is important thus to realize that there is no "better" research approach (Saunders et al., 2007). Both positions have strengths and weaknesses, and their place in the research process, whether used alone or as complementary tools for generating valid and valuable knowledge (Goulding 2002). However, we should compare and contrast qualitative and quantitative approach research designs taking into considerations strengths and weaknesses that might affect the above mentioned research context.

3.1 Quantitative Research

Berkman et al., 2009, Cheung et al., 2006 Cheung et al., 2009, Ge et al., 2010, Lei& Song 2011, Chen et al., 2009, Gordon & Henry 2005, and Chalevas 2009 and others, recorded a significant relationship between the presence and the volume of related party transactions and inflated earnings, decline of minority shareholder wealth, decline in firm value, and negative excess returns. Moreover, prior studies state that good corporate governance is an effective tool to lessen the opportunistic behavior of management, to improve a company's reporting quality, and to increase the value of a firm and move the related party transactions form the conflict of interest to efficient transactions (Denis & McConnell, 2003; Bhagat & Bolton, 2008, Gordon and Henry 2005, Chien and Hsu 2010, and AbdulWahab et al., 2010).

All of these studies used purely quantitative research designs to address related party transactions in relation to corporate governance on one side, and firm value/performance on the other side. This approach focuses mainly on what could already be known about related party transactions and corporate governance activities within the firms in the research sample. They normally draw or deduce a conclusion from rational theories (Lee and Lings, 2008), then collect data to test whether this deducted conclusion (Hypothesis) should be supported or not based on the statistical evidence provided. In most of the cases this evidence is provided using regressions or correlations.

Undertaking research on related party transactions quantitatively means that researcher have more tendency that any concepts used could be reasonably easily measured (Collis and Hussey, 2003). This could be achieved more successfully when quantitative and objective data which is not subject to the researcher's implementation is used.

This approach signals that reliability tends to be high in related party transactions research. This could be lying on the approach's usage of large sample sizes as well quantitative data. Also, it is important to mention that because positivism focuses on the precision of measurement and the ability to be able to repeat the experiment reliably, there is always a danger that validity will be very low (Collis and Hussey 2003).

The strengths of the quantitative research in summary lie mainly in:

- More precise estimates of how closely variables are related is provided (Bryman and Bell 2007).
- Data are in the form of objective numbers from precise measurement which is not subject to any interpretation or analysis by the researcher (Neuman 2006).
- Since the procedures are standard and replication is frequent (Neuman 2006), larger data sets could be used to enhance the increase of generalizations (Bryman, 2004).
- Measurement gives the researcher consistent device to identify differences between research subjects even if those differences are very fine (Bryman and Bell 2007).
- High reliability (Collis and Hussey 2003).
- Measurement is very important in quantitative research, therefore it allows the researcher to "delineate fine differences between objects" since it uses a consistent measure (Bryman and Bell, 2007).

On the other hand, quantitative research is being criticized for the following disadvantages:

- Quantitative researchers fail to distinguish people and social entities from the world of nature. This creates a static view of social life that is independent of people's lives (Bryman and Bell 2007).
- The measurement process possesses an artificial and fake sense of accuracy (Bryman and Bell 2007).
- Quantitative research is normally associated with low validity as previously discussed (Collis and Hussey 2003).

3.2 Qualitative Research

It is often introduced in terms of how it differs from quantitative research: that it doesn't rely on theory and most probably doesn't involve statistics (McQueen and Knussen, 2002) Moreover, quantitative data are not collected nor generated (Bryman and Bell, 2007). Qualitative research is concerned with understanding (interpreting) human behavior, focuses on interactive processes or events (Nueman, 2006), and uses only non-numerical data (Lee and Lings, 2008).

The qualitative research is usually undertaken from an inductive approach. Since it doesn't rely on a theory, therefore there is nothing subject to deduction, hypothesis, or testing. The inductive approach mainly focuses on moving from specific observations and trying to develop a theory (Lee and Lings, 2008). Such norm of studies can fall into the category of theory building (Collquit and Zapata-Phelan, 2007).

Adding this type of research to the domain of related party transactions will enrich the field and will develop new theories to be tested, rather than continuous testing of existing theories.

The qualitative approach has the following advantages:

- Validity is higher in the qualitative approach. Interpretive approach, to which the qualitative research belongs, focuses on capturing the essence of the phenomena the researcher claims to be investigating (Collis and Hussey 2003).
- In qualitative research the objects of social science (people) are capable of attributing meaning to their environments, this specific characteristic is not associated with quantitative research (Bryman and Bell, 2007).
- Qualitative researchers tend to provide more details in their research, thus enhancing the understanding of phenomena, rather than just quantifying its presence (Bryman and Bell, 2007).

On the other hand, quantitative research is being criticized for the following disadvantages:

- It relies on researcher unsystematic views and subjective information (Bryman and Bell, 2007).
- Since qualitative research is subjective, flexible, and has no any standard procedures to be followed, therefore replicating such type of research is very difficult (Bryman and Bell, 2007).
- The scope of the findings of qualitative research is restricted and they couldn't be generalized (Bryman and Bell, 2007).

4. Alternative methodology

Within the research domain of related party transactions and corporate governance, researchers relied mainly on quantitative research methods. The researchers measured corporate governance variables through composite indices or checklists. The aim of these measures is to quantify and determine the activities of corporate governance taking place within a company or a sample of companies. On the other hand related party transactions are quantitatively measured by the monetary value and the different types of related party transactions are identified.

Due to the nature of the research problem and its close relation to financial performance, it is difficult to argue that pure qualitative research will be of great value. However, mixing quantitative and qualitative research can contribute to the literature on both sides, theory building and theory testing as well.

For example the researchers could use semi-structured interviews with experts in the field in order to survey the most important corporate governance provisions that could be used as a tool to prevent, or directly protect the firm's financial performance against expected negative effects of related party transactions.

Mixed methods research provides strengths that compensate the weakness of the methodology used whether quantitative or qualitative by providing answers to research questions that cannot be answered through quantitative or qualitative research (Creswell and Plano Clark 2011).

Jick (1979) mentioned that mixing methods encourages productive research as well. However, the methodological triangulation is criticized for increasing the difficulty of replication, increases the expenses of data collection and analysis, and it is more time consuming (Hussey and Hussey 1997).

5. Conclusion

This essay critically evaluates the theory, paradigm, and methodology used to study related party transactions in previous study, its impact on firm value/performance, and the direct relationship that corporate governance might have with these variable. Studies about related party transactions are dominated by quantitative methodologies. The reason for this is the nature of the field and its strong reliance on secondary financial information; however quantitative research can only test existing theories. Therefore, qualitative research should be included to understand the relationship between these variables rather than just quantifying them or determining their existence. Although, qualitative researchers will significantly contribute to this field, it is suggested to involve qualitative methods as a part of mixed methodology research. The quantitative nature of the data will make mixing methods research more rigor and valuable than pure qualitative research.

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