OWNERSHIP CHARACTERISTICS, RELATED PARTY TRANSACTIONS AND FIRM PERFORMANCE: ANALYSIS OF LISTED FIRMS IN NIGERIA

BY

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ABSTRACT

Related party transactions (RPTs) have been a delicate and important phenomenon in accounting debates. Its effects on firm performance have been studied extensively in the developed Western market. The study of related party transactions in developing and emerging markets have been minimal due to weak corporate governance structures. Most of the empirical evidence in this regard relied heavily on the agency theory of "principal-agent" relationship based on the proposition that the ownership structure of firms is diffused. Recent studies have on the contrary, provided empirical studies pointing to the concentrated nature of ownership structures around the world tweaking the agency theory to a "principal-principal" relationship. The results, therefore, remain inconclusive. Compelling among the causes of the discrepancies include structures of ownership and differences in legal and cultural environments of reporting entities. As a result, emerging accounting literature on corporate governance is challenging the status quo arguing for the inclusion of country specific variables in the governance codes at the height of the International Financial Reporting Standards (IFRS) convergence agenda. As a response to these critical observations, this study focused on Nigeria, an emerging economy with a concentrated ownership structure, in an attempt to analyze how related party transactions impact the relationship between ownership characteristics and performance of firms listed on the Nigerian Stock Exchange (NSE). Standard panel regression method was used to analyze the available data for the chosen study period (2010-2013). The results of the study showed that only the ethnic composition of the board of directors was statistically significant and confirmed the apriori expectation of the study. This goes to show that country-specific corporate governance variables should be accorded more cognizance in accounting studies. In general, the results showed that, for the non-financial listed firms on the stock market of Nigeria, the moderating effect of RPTs was not significant statistically across the corporate governance variables in relation to firm performance except for the ethnic composition of the board of directors. Finally, the study also showed that despite the evolving nature of corporate governance codes in Nigeria, the results of the non-financial sub-sector of the listed firms portray some level of compliance with existing codes and operate within the ambits of global best practices.

خلاصة البحث

إن المعاملات مع الأطراف ذات الصلة ظاهرة حساسة ومهمة في المناقشات المحاسبة التي تم دراسة تأثيراتها على أداء الشركات بشكل رئيسي في السوق الغربي المتقدم. وكان معاملات أطراف ذات العلاقة في أسواق النامية والناشئة محدودة بسبب ضعف هياكل حوكمة الشركات. ومعظم الأدلة التجريبية في هذا الصدد تعتمد اعتمادا كبيرا على علاقة نظرية الوكالة بين الوكلاء الرئيسيين استنادا إلى الافتراض بأن هيكل ملكية الشركات منتشرة. وقد خلصت الدراسات الموضوعية الأخيرة على العكس من ذلك، أن دراسات تجريبية تثبت الطبيعة المركزة لهيكل الملكية في جميع أنحاء العالم، وهي تعدل نظرية الوكالة إلى العلاقة "الرئيسية – الرئيسية". ولا تزال النتائج المترتبة عليها غير حاسمة، ومن بين أسباب التناقضات هيكل الملكية والاختلافات في البيئة القانونية والثقافية للكيانات التي تقدم التقارير. ونتيجة لذلك، فإن الأدب المحاسبي الناشئ حول حوكمة الشركات تشكل تحديا للوضع الراهن الذي يطالب بإدراج المتغيرات الخاصة بكل بلد في قوانين الحوكمة في ذروة جدول أعمال المعايير الدولية (IFRS) للبرامج التقارب. وردا على هذه الملاحظات الهامة، ركزت هذه الدراسة على نيجيريا، وهي اقتصاد ناشئ ذات هيكل ملكية مركزة، في محاولة لتحليل كيفية تأثير المعاملات مع الأطراف ذات العلاقة على العلاقة بين خصائص الملكية وأداء الشركات المدرجة في بورصة نيجيريا. طريقة انحدار لوحة قياسية لتحليل البيانات المتاحة لفترة الدراسة المختارة (2010-2013). وأظهرت نتائج الدراسة أن تكوين مجلس الإدارة الإثنية هي المتغيرة الوحيدة ذات دلالة إحصائية وأكدت التوقعات المتوقعة للدراسة. ويوضح ذلك أن متغير حوكمة الشركات الخاصة بالبلد ينبغي أن يعطى مزيدا من الإدراك في الدراسات المحاسبية. وبصفة عامة، أظهرت النتائج أنه بالنسبة للشركات غير المالية المدرجة في سوق الأوراق المالية في نيجيريا،أن (RPT) لم يكن التأثير المعتدل ذات دلالة إحصائية عبر متغيرات حوكمة الشركات فيما يتعلق بالأداء الثابت باستثناء التركيبة العرقية لمجلس الإدارة. وأخيرا، أظهرت الدراسة أيضا أنه على الرغم من الطبيعة المتطورة لمدونات حوكمة الشركات في نيجيريا، فإن نتائج القطاع الفرعي غير المالي للشركات المدرجة تصور مستوى الالتزام بالامتثال للقوانين القائمة وتعمل ضمن نطاق أفضل الممارسات العالمية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature………………………. Date…………………………….

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LIST OF ABBREVIATIONS

AMCON	Asset Management Company of Nigeria
ASEAN	Association of South East Asian Nations
AU	African Union
BOD	Board of Directors
BOFIA	Banks and Other Financial Institutions Act
BRIC	Brazil Russia India and China
BSE	Bombay Stock Exchange
CAC	Corporate Affairs Commission
CBN	Central Bank of Nigeria
CEO	Chief Executive Officer
DIFX	Dubai International Financial Exchange
EU	European Union
FASB	Financial Accounting Standard Board
FDI	Foreign Direct Investment
FE	Fixed Effect
FEC	Federal Executive Council
FIRS	Federal Inland Revenue Services
GAAP	Generally Accepted Accounting Practices
GLCs	Government Linked Companies
IAS	International Auditing Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IGR	Internally Generated Revenue
IPO	Initial Public Offering
IRRC	Investor Responsibility Research Centre
ISE	Istanbul Stock Exchange
JSE	Johannesburg Stock Exchange
MINT	Mexico Indonesia Nigeria and Turkey
NAICOM	National Insurance Commission
NASB	National Accounting Standard Board

NDIC	Nigerian Deposits Insurance Companies
NSE	Nigeria Stock Exchange
OAS	Organization of American States
OECD	Organization for Economic Cooperation and Development
PCAOB	Public Company Accounting Oversight Board
PENCOM	National Pension Commission
POLS	Pooled Ordinary Least Square
RE	Random Effect
ROA	Returns on Asset
ROAE	Returns on Average Earnings
ROCE	Returns on Capital Employed
RPTs	Related Party Transactions
SAS	Statement of Accounting Standards
SEC	Securities Exchange Commission
SOEs	State Owned Enterprises
SOX	Sarbanes Oxley's Act
SPSE	Sao Paolo Stock Exchange
UK	United Kingdom
US	United States
WTO	World Trade Organization

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Firm performance has been extensively researched in relation to dispersed ownership structure subsequent to the seminal paper of Jensen and Meckling (1976). The study of Demsetz (1983), Shleifer and Vishny (1986), Morck et al., (1988), La Porta et al., (1998), 1999 and Bhaumik and Gregoriou (2010) have however pointed out that recent studies on ownership structure are gradually converging and accepting the fact that most economies of the world operate concentrated ownership structure against the widely held view of dispersed ownership. It is therefore becoming a growing necessity to study and understand how concentrated ownership impact on the performance of firms especially in emerging markets.

The daunting challenge is that most emerging markets face the problem of inadequate reporting of their firm performance due to the weaknesses of their corporate governance framework and regulatory environment. This continues to result in huge loss of investments and thus erode the trust users of financial information have in their reported firm performance, (Kohlbeck & Mayhew, 2010). Though the challenge is not specific to emerging markets, thus strengthening corporate governance implementations and practices of listed firms remain the viable solution to ameliorate the current challenges. In this regard, for example, Abbott, Park and Parker (2000), Abdullah (2004), Beasley (1996), Bhagat and Black (1999), Gill and Obradovich (2012), Lawal (2012), Mangena, Tauringana and Chamisa (2012), Uadiale (2010) studied board characteristics on performance, Abbott et al., (2000), Karamanou and

Vafeas (2005), Klein (2002), Krishnan (2005), Lennox (2005), Rainsbury, Bradbury and Cahan (2009) audit committee structure and constituents, Chahine and Filatotchev (2011), Gill and Obradovich (2012), Kealey, Ho-Young and Stein (2007), Menon and Williams (2001), Pandit and Rubenfield (2011), Rainsbury et al., (2009), Stanley and Todd DeZoort (2007) audit firm independence and influence, Bhattacharya and Graham (2009), Zhilan, Cheung, Stouraitis and Wong (2005), Claessens and Djankov (1999), Demsetz and Villalonga (2001), Gill and Obradovich (2012), Patro (2008), Seifert, Gonenc and Wright (2005), Thomsen and Pedersen (2000), Welch (2003) ownership structure effects and Font, Walmsley, Cogotti, McCombes and Häusler (2012), Sami and Zhou (2008), Tang, Du and Hou (2013) on firm disclosure, all in efforts geared towards bolstering the reporting of firm performance and increase the assurance of users.

In spite of the extensive studies that have dwelt on unravelling the relationship between the various corporate governance components and firm performance, Boţa-Avram (2013) and Grosfeld (2009) posit that a broader analysis of these studies revealed apparent disparities in their various conclusions. While the results of some studies show a positive relationship between concentrated ownership structure and firm performance, others highlight inverse relationship. Lawal (2012) pointed out that the variances in the findings across studies are due to the fast changing business and economic landscape as well as the regulatory dynamism of the global markets. He further maintained that such circumstances have brought legitimacy to the continuous inquiry onto the link between corporate governance variables and firm performance. In fact, in a current study covering Brazil, India, Korea and the Russian Federation, (Black, de Carvalho, & Gorga 2012) revealed that there are wide variations in the effects of applications of different corporate governance practices and variables across these countries and even the sizes of their respective firms.

One of such variables that has received less research attention, and where there are, remains inconclusive, and which exhibit substantive effect on virtually all the recent reported financial improprieties as noted (Gordon, Henry, Louwers & Reed, 2007; Henry, Gordon, Reed & Louwers, 2007; Lo, Wong & Firth, 2010), is the nature and extent of Related Party Transactions (RPTs), and its effect on firm performance.

Related party transactions simply refer to a set of transaction that is undertaken with persons or entities having direct or implicit business relation not at arm's length. Statement of Financial Accounting Standards No. 57 referred to it as the business dealings that subsist between a firm and its subsidiaries, affiliates, controlling owners, officers or their relatives, directors or their relatives, or corporations owned or controlled by its officers or their relatives. Acting as conduit in the transfer of undisclosed wealth to business associates, few studies have identified the culpability of RPTs in the event of firm failure due to manipulation of financial performance. Gordon et al. (2007) noted that despite efforts by regulatory authorities especially with the introduction of Sarbanes-Oxley to reduce materially implicating RPTs, studies reveal that most firms still engage in RPTs. This is because as reiterated by AICPA (2001), RPTs has remained difficult to audit due to some inherent problems identified as: (1) difficulty in identifying RPTs for the purpose of examination, (2) reliance on management by the auditor for the provision of necessary information and explanations on RPTs, and (3) inappropriate internal control to capture RPT.

In another but related dimension, RPTs has a phenomenon, albeit the paucity of available literature on its relationship with performance has generally been studied within the confines of diffused ownership structure and environment with strong legal framework such as US, Canada and Europe, (Chau & Gray, 2002). It is therefore questioned that if the presence of RPTs could have warranted such significant peril on large companies such as Enron, WorldCom, etc., in a diffused ownership setting like the United States, examining its focal influences on the markets of developing economies that are characterized with concentrated ownership structure remains a daunting and veritable research option.

Concentrated ownership structure is an arrangement where a portion of the shareholders possess significant equity holdings that earn them controlling interest[1] in public listed firms. Large shareholdings entitle the holders access to domineering effect and private benefit of control which research studies have produced mix results on the direction of their effects on firm performance (Claessens, Djankov, Fan & Lang, 2002; Shleifer & Vishny 1997). Jensen and Meckling (1976) highlighted that concentrated ownership can subdue agency problem arising from the conflicts of interest between owners and managers of firms due to dedicated involvement in the business to maximize returns by capital providers. Other studies such as Bozec and Laurin (2007) have however expressed caveat that excessive power at the behest of controlling shareholders might lead to entrenchment[2] capable of disrupting the corporate government mechanisms and could create room for tunnelling[3]. The presence of entrenchment and tunnelling create a systematic bifurcation between large and minority shareholders with respect to cash flow rights and voting rights

[1] A controlling interest is earned when shareholders, who can either, be government, institution or an individual hold more than 50% of the equity of the firm.

[2] Bozec and Laurin (2007) described it as the resultant effect of large control where dominant shareholders exploit their position to advance their personal interests at the expense of minority interest holders.

[3] Tunnelling, a means of transferring cash, goods, assets or other wealth of firms among related firms by subjugating the arm's length procedures, occurs mostly in the presence of RPTs in a concentrated ownership setting (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2008).

Bearing this in mind, when firms act mainly at the whims of the large shareholders, they restrict good corporate governance and tramples upon the rights of the minority interest holders. More importantly, studies on the impacts of large shareholders considering the influence of RPT on firm performance have received little attention and providing mixed results where it did.

Completing the third tier of identified challenges affecting the performance of firm, is the cross cultural dimensions of tribal and ethnic plurality and the sentiments it exerts in influencing the structure of business ownership and the parties it opts for during regular and intimate business transactions. Crane et al., (2008) expresses that this social aspect of business continues to be of influence in corporate decision making such that it is fast acquiring what in political parlance is referred to as authoritative allocation of values and resources status.

Prominent studies in this area such as Gray, Kouhy and Lavers (1995), Meek and Gray (1989), Meek et al. (1995) and Turpin and DeZoort (1998) concentrate on countries like the US, the UK and Europe which on individual basis has little or no ethnic and cultural polarizations. Few studies like Chau and Gray (2002) and Claessens et al. (2002) delved into Asia’s emerging markets including a country like Malaysia with distinct ethnic and cultural pluralism which have bearing on its economic framework. Research efforts however remain inconclusive in capturing this salient feature in the determination of firm performance in a concentrated ownership setting of developing economies.

Considering the significant influence ethnic affinity could exert in deciding the choice(s) of business partners, selection and composition of board including merger and acquisitions where and when necessary, existence of adequate corporate governance mechanisms that will mitigate the uninhibited use of information asymmetry and private benefit of control by controlling shareholders should be of paramount importance especially in emerging economies that are characterized by weak legal and regulatory framework.

Owing to the foregoing, this study focuses on Nigeria, an emerging economy with concentrated ownership structure, in an attempt to analyze how related party transactions impact on the relationship between ownership characteristics and performance of firms listed on the Nigeria Stock Exchange. This is predicated on the understanding that although there are some empirical evidences on the theoretical underpinning as well as empirical evidences of the various paradigm providing linkages to performance of firms but there exist few studies considering the analysis of the effects of the integration of these constructs especially from the perspectives of emerging economies.

1.1.1 The context of the Study

Related party transactions have been a delicate but isolated topic in accounting literature. Delicately because of the uncertainties surrounding the identification of its underlying nature, especially with respect to ascertaining whether it was carried out in the interest of the firm or antithetical to the goals and aspiration of the shareholders. Some studies such as Nekhili and Cherif (2011) argues that RPTs result in tunnelling which could lead to the expropriation of minority interest holders, while others, such as La Porta, Lopez-de-Silanes and Zamarripa (2003) reported that it could be used for propping up businesses to avoid insolvency, a move that would ensure benefits for all stakeholders. However, Chatterjee, Mir and Al Farooque (2009) asserted that the impacts of RPTs on firm performance can no longer be overlooked as it has in recent times inflicted debilitating effects on the image of financial statements, the auditing procedures and the regulatory frameworks.

In the United States, even after the promulgation into law of the Sarbanes Oxley (SOX) 2002 aimed at tightening the corporate governance codes to improving the reporting quality, Gordon and Henry (2005) highlighted that RPTs remain a scourge as it is regarded as one of the nine potent mechanisms responsible for the restatement of financial reports by corporate firms. RPTs became more prominent when in the 2001 fraudulent financial reporting involving Enron, Tyco and Adelphia, RPTs was singled out as the major tool of financial impropriety used by the directors of those companies.

In Nigeria, the incidences of fraudulent RPTs became a subject of serious of concern when the Central Bank of Nigeria (CBN), under the leadership of Professor Charles Soludo, increased the market capitalization of commercial banks from two billion naira (N2b) to twenty-five billion (N25b). This was meant to improve the quality of service delivery and market penetration, mitigate bank runs and protect depositors' funds, reduce their over-reliance on government deposits and foreign exchange trading and compete favourably in the international markets[4]. The time given (June 2004 to December 2005) to raise the fund was however short for the banks to comply (Bernard & Obialor, 2014). The situation was further compounded with the restriction imposed on foreign investors to only acquire 10% shareholdings in banks having Nigerians as majority shareholders. In order to meet up with the 18 months' recapitalization ultimatum, most of the banks went into consolidation using merger and acquisition.

The consolidation exercise reduced the number of banks from 89 to 25 and left excessive idle funds at the disposal of the banks whose extent and nature of products

[4] http://www.studymode.com/essays/The-Effect-Of-Bank-Capitalisation-On-576951.html 27-05-14

development and coverage did less to put the enormous capital into productive use. As a consequence, and in attempts at utilizing those idle funds, the banks' directors and management engaged in RPTs generally to giving out loans to, and financing the businesses of their cronies without observing due checks and viability of such businesses.

In 2009, the new administration of the CBN led by Mallam Sanusi Lamido Sanusi favoured specialized system of banking as against the Universal Banking System (UBS) propagated by his predecessor, Professor Charles Soludo. In Sanusi Lamido's estimations, the universal banking system produced less of the desired results on its functions as fulcrum of financial intermediation and backbone of economic development at all levels. Pursuant to this, the CBN conducted routine examination of the books of accounts of 14 banks as allocated to it by the Nigerian Deposit Insurance Companies, (NDIC) under the sharing arrangement[5] to ascertain their financial healthiness. They discovered a huge level of earnings management wherein RPTs were used as conduit for transfer of wealth among their cronies at the expense of the minority interest holders.

Given the above, this study examines the moderating impact of RPTs on the relationship between identified ownership characteristics and corporate firm performance.

[5] http://en.wikipedia.org/wiki/Sanusi_Lamido_Sanusi 06-12-14

1.2 STATEMENT OF PROBLEM

Previous studies have identified that weak corporate governance has a negative impact on firm performance. Nonetheless, Henry (2010) asserted that despite the increasing empirical evidence showing significant linkages between some of corporate governance variables and firm performance and the results of firm's valuation, medium through which governance variables impact on firm performance have remained too long unattended to as the process continue to be shrouded in secrecy.

Demsetz and Villalonga (2001) corroborated the assertion when they noted that although structure of the ownership plays vital role in the determination of firm performances but the how has been a subject of long debate. Various empirical evidences have been advanced but Demsetz and Villalonga (2001) concluded that the aggregation of their arguments and results are not potent enough to disprove the existence of relationship between the performance of firm and managerial equity ownership.

Recently, the events leading to the global financial crisis highlighted the culpability of RPTs and has been observed to be the systematic method employed to manipulate firm performance which has the potency to expropriate minority interest holders and other stakeholders (Bhaumik & Gregoriou, 2010; Cheung, Rau, & Stouraitis, 2006; Stijn Claessens & Djankov, 1999; Harris & Raviv, 1988; Henry et al., 2007; Patro, 2008; Yeh, Shu, & Su, 2012).

In Nigeria, the scourge of RPTs ravaged the capital markets via the financial subsector of the Nigeria Stock Exchange (NSE). Eight banks[6] failed the CBN's joint

[6] The banks include: Spring Bank, Intercontinental Bank, Union Bank Plc, Oceanic Bank Plc, Afribank Plc, FinBank, Bank PHB and Equitorial Trust Bank Limited.