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Do related party transactions matter for firm performance? LQ 45 firm perspective

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ABSTRACT

This study aims to provide empirical evidence regarding whether related party transactions (RPTs) are really a matter for company financial performance. It also investigates other possible factors that may influence firm performance such Covid 19 pandemic situation, company size and sales growth. The samples are obtained from companies recorded in the LQ 45 index in 2019 which were studied from 2018 to 2021. The results shows that RPTs do not significantly influence firm performance. This happens because companies do not rely on related party relationships in the sales or purchasing process. In addition, Covid 19 and company size have a significant negative impact on ROE and ROA. Whereas sales growth has a significant positive relationship on firm performance. This indicates that having a large asset investment does not guarantee an increase in the company's financial performance. A strategy that focuses on increasing sales will be more profitable.

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INTRODUCTION

Related Parties Transactions (RPTs) are an interesting and important issue for companies throughout the world, especially companies listed on the stock exchanges of each country. In Indonesia, accounting provisions for RPTs are contained in Statement of Financial Accounting Standards No. 7 (PSAK 7) concerning Disclosures of Related Parties. According to the standard, a related party transaction is a transfer of resources, services or obligations between the reporting entity and related parties, regardless of whether a price is charged.

RPTs are essentially able to bring profits to the company such as obtaining and selling substantial assets between related parties (Mustafa et al., 2011). In another study, Bansal & Thenmozhi (2020) found that companies in India use RPTs as an efficient transaction mechanism. They argue that firms undertaking RPTs are associated with higher firm value and this result is even stronger for firms with higher ownership concentration.

On the other hand, RPTs can have an adverse impact and cause many losses to shareholders. The Enron scandal that occurred in 2001 is one example of the misuse of RPTs which

brought losses to shareholders at that time. Furthermore, in Indonesia, the case involving PT Tiga Pilar Sejahterah Food Tbk (AISA) in 2019, supports that RPTs can have a negative effect on company performance and lead to financial fraud. Several studies (Hendratama & Barokah, 2020; Wang et al., 2019) also report a negative relationship between these transactions and company value. While Wulandari et al., (2022) found during 2018-2019, RPTs were conducted for opportunistic purposes.

Other empirical studies found an insignificant impact of RPTs on company performance. Using a sample of manufacturing companies in Nigeria during the 2006-2014 period, Umobong (2017) did not find a significant relationship between RPTs and company ROA and EPS. Okoro & Jeroh (2016) and Anastasia & Onuora (2019) also drew similar conclusions after examining companies listed in Nigeria but in different time periods.

The objective of this study is to examine whether RPTs really have effect on firm performance and what factors that probably matter for firm performance. The author classified RPTs into two categories: RPTs from account payable and RPTs from account receivable. Besides, it also includes several independent variables to understand what factors that have greater influence to firm performance, namely Covid 19 pandemic, company size and sales growth.

Because the study sample was carried out by taking information from the annual report for the 2018-2021 period, the Covid pandemic becomes second independent variable. In the 2020 period, the world, including Indonesia, was shocked by the presence of Covid 19. This disease is caused by a new virus called SARS-CoV-2. According to Devi et al. (2020) there are differences in company performance as seen from financial ratios between the period before and after COVID19, where profitability ratios have decreased. Prawoto et al. (2020) reported that there was a negative relationship between the Covid 19 pandemic and socio-economic mobility, especially in the recreation sector, daily necessities, pharmacy, recreation sector, grocery and pharmacy sectors, transit stations and workplaces. On the other hand, a survey conducted by Krajewsk et al. (2020) report that there are positive aspects to this phenomenon, such as the optimization of paid work and the opportunity for systemic change in institutions.

Furthermore, this study also includes other independent variables which are thought to support the company's profitability value, such as company size and sales growth. Several studies show that there is a significant positive relationship between company size and sales growth and company performance (Hendratama & Barokah, 2020; Wang et al., 2019). On the other hand, another study conducted by Abeyrathna & Priyadarshana (2019) reported that company size has no influence on the profitability of manufacturing companies. Company size is obtained by calculating the natural logarithm of total assets (Hendratama & Barokah, 2020), while sales growth is obtained from the percentage change in sales from the previous year.

RESEARCH METHOD

This research is quantitative research that uses secondary data collected from annual financial reports published on the Indonesia Stock Exchange. Data analysis was carried out using the Generalized Least Square (GSL) method and processed with STATA 16 software. This study sample was carried out on companies classified as LQ 45 companies in the year of 2019 and they were observed for 4 periods, from 2018 to 2021. Samples were taken from non-financial companies which had gone through a selection process with high liquidity and several other selection criteria. LQ 45 was chosen because the companies included in this index are a combination of issuers with high liquidity so that they can be an objective and reliable tool for financial analysis, investment managers, investors, and also capital market observers.

International Accounting Standards No. 24 (IASB, 2023) defines a related party as a person or entity that is related to the entity that prepares its financial statements (referred to as a 'reporting entity'). Furthermore, related party transactions are defined as the transfer of resources, services, or

obligations between related parties, regardless of whether a price is charged. Statement of Financial Accounting Standards (PSAK) No. 7, requires disclosure of all related parties in the company's financial reports and explicitly states that related parties are entities or people related to the entity that issues the financial reports. These related parties are usually referred to as affiliated parties through several possible connections.

Conflict of interest theory predicts a negative relationship between RPTs and firm performance. Jensen and Meckling (1976) first proposed agency theory which discusses type I agency problems between managers (agents) and owners of economic resources (principals). Furthermore, Shleifer & Vishny (1997) stated that there was a conflict of interest between minority shareholders and controlling shareholders which was later identified as a type II agency problem. Type II agency problems arise when a company has an ownership structure that arises because according to Lim & Yen (2011), the decisions of the largest controlling shareholder can affect the company's performance and also the wealth of minority shareholders. Furthermore, Shleifer & Vishny (1997) state that the largest controlling shareholder tends to act based on his own personal interests which are not always in line with the interests of other shareholders, or with the interests of employees and managers. Therefore, in the process of maximizing his personal welfare, the largest operator shareholder can transfer wealth between related parties under his control at the expense of the minority shareholder's wealth.

On the other hand, there are different views explaining the economic incentives for conducting RPT. Efficient contract perspective (Khanna & Palepu, 2000) assumes that close interaction between related parties allows them to reduce transaction costs compared to arm's length transactions. Following this view implies that RPT can be beneficial to firm performance (Gordon et al., 2007; Ryngaert & Thomas, 2012), especially in emerging markets with less developed intermediary institutions (Fang et al., 2018).

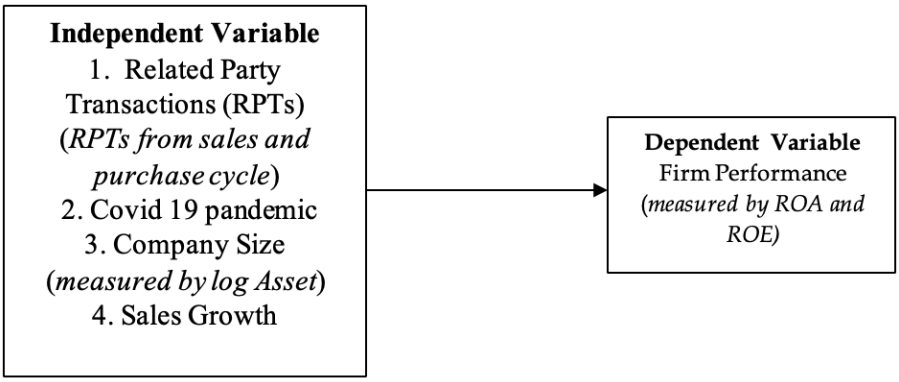

Figure 1. Research Model

RPTs in this study are divided into two. First, the RPTs that arises in the revenue cycle (RPTREV), measured by dividing the total trade receivables from related parties with the company's total assets. Second, RPTs (RPTDEBT) is obtained from the purchasing cycle, obtained by dividing related party trade debt divided with total assets.

$RPTREVi,t=(Total\ RPTs\ Reveivable_{i,t})/(Total\ Asset_{i,t})$ ……..…….…..…(1)

$RPTDEBTi,t=(Total\ RPTs\ Payable_{i,t})/(Total\ Asset_{i,t})$……..……..(2)

Furthermore, there are other three independent variables in this research, namely the Covid 19 pandemic, company size and sales growth. The Covid 19 (COVID) pandemic is measured by giving 1 point for years affected by the pandemic or 2020 and 2021 and a value of 0 for years free from the impact of the pandemic or 2018 and 2019. Company size (SIZE) is measured by the logarithm of total assets. Meanwhile, sales growth (Growth) is measured by the percentage change in sales.

$COVID_{i,t}$ = 1 Point for periode of 2020-2021, dan 0 Point for period of 2018-2019 ……..……(3)
$SIZE_{i,t}$ = Log (Total $asset_{i,t}$)……..……..…..……..……(4)
GROWTHi,t =($Sales_{i,t}$ - $Sales_{i,t-1}$)/($Sales_{i,t-1}$)……..……..……(5)

The dependent variable in this research is financial performance, which is measured by two ratios, namely return on equity (ROE) and return on assets (ROA). ROE is one of the key aspects of a company's profitability in an accounting-based measure and shows the proportion of a company's income generated using its own equity, namely money obtained from shareholders. This ratio shows the efficiency of using own capital. The higher this ratio, the better, meaning the company's position is stronger and vice versa. (Kasmir, 2012). Investors who analyze ROE could get an idea of which company is better at generating profits and thus has a competitive advantage. Owning shares of companies with competitive advantages leads to higher returns for investors (Tjurins & Nikitins, 2011). Meanwhile, ROA according to Rivai et. al. (2013) is the company's ability to utilize its assets to earn profits. This ratio measures the level of return on investments made by the company using all the funds (assets) it owns. The greater the ROA, the greater the level of profit achieved and the better a company can use its assets. ROE and ROA are obtained with the following equation.

ROEi,t=(Net $Income_{i,t}$)/(TOTAL $EQUITY_{i,t}$) ……..……..……..……..(6)
ROAi,t=(NetIncome$_{i,t}$)/(TOTAL $ASSET_{i,t}$) ……..……..……..(7)

Therefore, the regression model in this study is formulated as follows:

$FP_{i,t} = \alpha_0 + \beta 1RPTREV_{i,t} + \beta 2RPTDEBT_{i,t} + \beta 3Cov_{i,t} + \beta 4Size_{i,t} + \beta 5Growth_{i,t} + e$ ……..……..(8)

Where:
$FP_{i,t}$ = Financial performance (measured by ROE and ROA) in company i in period t
$RPTREV_{i,t}$ = Related party transactions originating from trade receivables at company i in period t
$RPTDEBT_{i,t}$ = Related party transactions originating from trade debts at company i in period t
$Cov_{i,t}$ = Covid 19 pandemic in company i period t
$Size_{i,t}$ = Company size in company i period t
Growthi,t = Sales growth in company i in period t

This research uses panel data which is a combination of time series and cross-sections to see the diversity of characteristics of each data observation over time from 2018 to 2021. Therefore, there are three types of modeling data, namely (1) fixed effects model, (2) general effects model and (3) random effects model. To determine which method is more appropriate to use, testing must be carried out. Testing aims to ensure that the method used matches the characteristics of the sample used, so that the estimation process provides the best results. In this study, the Chow Test, Lagrange Multiplier (LM) Test and Hausman Test were carried out.

H0: Related party transactions, the Covid-19 pandemic, company size and sales growth have no effect on financial performance.
H1a: Related party transactions have a positive effect on financial performance.
H1b: Related party transactions have a negative effect on financial performance.
H2a: The Covid-19 pandemic has a positive effect on financial performance
H2b: The Covid-19 pandemic has a negative effect on financial performance
H3a: Company size has a positive effect on financial performance
H3b: Company size has a negative effect on financial performance
H4a: Sales growth has a positive effect on financial performance
H4b: Sales growth has a negative effect on financial performance.

RESULTS AND DISCUSSIONS

This research uses the winsorizing technique to reduce distortion due to data conditions that are too extreme or outlier data which can create bias in processing data at the assumed limits of 1% and 99%. This research also overcomes the problem of outlier data by using identification based on standard deviation using STATA 16. The total research sample was 29 companies over 4 years, namely from 2018 to 2021. Thus, the total observations used in this research were 166 observations.

Table 1. Research Sampling Selection

Number of LQ 45 companies	45
Number of Financial Companies	(7)
Companies who experience loss during 2018-2021	(4)
Incomplete data	(5)
Total sample	29
Total Observations	116

The average percentage of RPTs to total assets in LQ 45 companies experienced a slight decrease from 2018 - 2021. Figure 2 also explains that the RPTs that occurred in companies in this index came more from sales transactions than purchases.

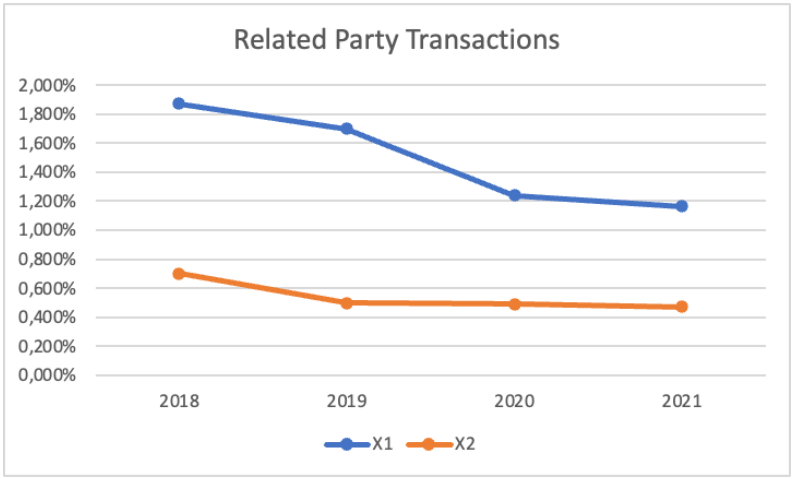

Figure 2. RPTs Trends

This study also carries out descriptive statistical analysis of the variables involved in the estimation model. According to table 2, the minimum value of related party transactions, whether originating from income or purchases, is 0. This indicates that the companies included in this index do not really rely on transactions between related parties. Meanwhile, the positive mean values for ROE and ROA show that during the 2018-2021 period the average company generated positive profits even though there were companies experiencing losses during that period. This is also supported by a positive average income growth rate.

Table 2. Descriptive Statistics

Descriptive statistics						
	Obs	Mean	Median	Std Dev.	Min	Max
ROE	116	0.1049	0.100	0.07180	-0.17973	0.29515
ROA	116	0.0621	0.0572	0.04692	-0.05722	0.24030
RPTREV	116	0.0149	0.0021	0.03339	0	0.21470
RPTDEBT	116	0.0054	0.0014	0.01222	0	0.08126
SIZE	116	13.680	13.703	0.35361	12.78804	14.5650
COVID	116	0.5	0.5	0.50217	0	1

SALESGRWTH	116	0.1019	0.075	0.31254	-0.47983	1.88225

To select the most appropriate estimation model in analyzing dependent and independent variables, the Chow test, Hausman test and LM test were carried out using STATA software. First, this research carried out tests to see the most appropriate regression model between the Pooled Least Square (PLS) and Random Effect (RE) models using Breusch-Pagan Lagrange Multiplier Test. Second, this research examines the best model between the Pooled Least Square (PLS) Model and the Fixed Effect (FE) Model using the Chow test. Third, this research tests the model between the Random Effect (RE) Model and the Fixed Effect (FE) Model using the Hausman Test. Based on a series of tests carried out, this study implemented a random effect model in carrying out estimation tests.

Table 3. Estimation Model Selection

	Y=ROE	Y=ROA
LM Test		
Prob > chibar2	0.00000	0.00000
Result	Random Effect	Random Effect
Chow Test		
Prob > F	0.00000	0.00000
Result	Random Effect	Random Effect
Hausman Test		
Prob>chi2	0.0782*	0.3285*
Final Decision	Random Effect	Random Effect
Normality (Shapiro-Wilk W) Test		
Prob > z	0.06529	0.07878
Notes: * p > 5%		

Furthermore, this study also conducted a normality test in the estimation model. The assumption of normality plays an important role in decision making. The normality of the residuals from a regression determines whether the data can be tested using a particular test statistic. A summary of the results of the estimation model selection test and normality test is presented in Table 3.

Table 4 shows the relationship between the independent variable and the dependent variable. The analysis results show that both models have an f-statistic value below 5% so that all independent variables simultaneously have an influence on both profitability ratios with a significance level of 5%. Next, to measure how well the observed variables are replicated by the model, the coefficient of determination R2 is tested. The R2 value shows that the proportion of ROE and ROA explained by the explanatory variables is 26.39% and 27.56% respectively.

Even though the f-statistic results show that the independent variables together have a significant influence on the dependent variable, using the t test, there are independent variables that individually have no effect on ROE and ROA. It can be also seen that RPTS do not have a significant influence on the two profitability ratios, RPTs resulting neither from sales or from purchases. This is also supported by the results of descriptive statistical analysis shown in table 2 that not all companies observed have RPTs, either from sales or purchases. On the other hand, the means of ROE and ROA show positive values, even though the ROE and ROA are not supported by RPTs.

This result is similar as several previous results. Study conducted by Umobong (2017) found that there was not a significant relationship between RPTs and ROA so that RPTs were not used to manipulate firm ROA. Okoro & Jeroh (2016) also found no casue-effect link between RPTs and financial performance in Nigeria. Furthermore, Anastasia & Onuora (2019) also drew similar conclusions after examining companies listed in Nigeria but in different time periods.

Moreover, the results of empirical studies also show that the Covid 19 pandemic phenomenon has a significant negative effect on ROE and ROA. These results support the opinion

that limited community mobility can have an impact on the activities of various industrial sectors, resulting in a decrease in average income (Prawoto et al., 2020), even though the companies observed in this study have high asset liquidity values.

Table 4. Result Analysis

	ROE	ROA
RPTREV	-0.0409 (0.88)	-0.0005 (0.99)
RPTDEBT	0.3485 (0.66)	-0.0852 (0.87)
SIZE	-0.0443* (0.10)	-0.0588*** (0.001)
COVID	-0.0187** (0.03)	-0.008* (0.06)
SALESGRWTH	0.0612***(0.00)	0.0255*** (0.00)
Constant	0.7137	0.8676
Obs	116	116
R^2	0.2639	0.2756
F-statistic (Prob > chi2)	0.0000	0.0000

Notes: ***p<0.001; **p<0.05; p* < 0.1

Company size appears to have a significant negative influence on profitability ratios. Conversely, sales growth has a positive effect on the company's ROE and ROA. This result is not similar as previous research conducted by Hendratama & Barokah (2020) and Wang et al. (2019) where company size positively influenced firm performance. However, this study gives a new perspective that although larger companies have more resources than smaller companies, this does not guarantee that the larger companies will generate higher levels of returns. The authors assume due to limited community mobility during pandemic, the companies experienced several difficulties to maximize the use of their assets in their business activities. Alternatively, a strategy that focuses on increasing sales will be more profitable for the companies, especially during uncertain environmental condition such as pandemic.

CONCLUSION

This research discusses whether RPTs have an effect on firms performance and what factors that influence firm performance. The research gives evidence that there is no significant influence between RPT and firm performance. This happens because the companies observed do not depend on RPTs to generate profits. More important, there were companies that had absolutely no transactions with related parties during period of study. Meanwhile, the Covid 19 pandemic and company size have a significant negative influence on ROE and ROA, but sales growth has a significant positive relationship with the profitability ratio. This research gives empirical evidence that larger asset investments do not always guarantee increased firm performance, especially during uncertain environmental issue, such as pandemic. Thus, companies should focus on strategies to maintain their sales growth in order to earn higher profit.

The results of this research can be applied to developing country markets with company characteristics that have high liquidity values. However, the impact of RPTs, pandemic situation, company size and sales growth on company performance can vary by country. Cross country research will be recommended to get understanding of what companies really need to increase their performance. The authors also suggest companies to consider environmental factors in order to sustain their long-term performance. In addition, this study only discusses RPTs originating from business credit and business debt. Therefore, future research is recommended to consider types of RPTs originating from other sources.

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