Pacific-Basin Finance Journal 29 (2014) 272–296

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

The association between related-party transactions and control–ownership wedge: Evidence from Korea

Minjung Kang [a], Ho-Young Lee [a,*], Myung-Gun Lee [b], Jong Chool Park [c]

[a] *School of Business, Yonsei University, Republic of Korea*
[b] *School of Business, Yeungnam University, Republic of Korea*
[c] *College of Business & Public Administration, Old Dominion University, United States*

A R T I C L E I N F O

Article history:
Received 29 January 2013
Accepted 26 April 2014
Available online 14 May 2014

JEL classification:
G30
M40

Keywords:
Related-party transactions
Control–ownership wedge
Control rights
Cash flow rights
Chaebol firms

A B S T R A C T

In this study, we examine whether related party transactions (RPT) are used as a mechanism for tunneling among firms belonging to large business groups in Korea (chaebols). Using 982 firm-year data of publicly traded firms in Korea, we find that the control–ownership wedge is positively associated with the magnitude of RPTs. RPTs increase as voting rights increase, while RPTs decrease as cash flow rights increase. The control–ownership wedge is more closely related to RPTs among the top 5 chaebol firms where the agency conflicts between the controlling shareholders and the minority shareholders are more severe than in non-top 5 chaebol firms. While the significant positive association between the control–ownership wedge and RPTs holds for both operating and non-operating RPTs, we find that non-top 5 chaebols use only non-operating RPTs whereas the top 5 firms use both operating and non-operating RPTs. Finally, we find that RPTs of Korean chaebol firms, on average, reduce firm value, but this value destruction is observed only when the control–ownership wedge is high and is more pronounced with the top 5 chaebol firms. Overall, our results together suggest that RPTs occur when the agency problem is severe and they are used as a means of tunneling, thus destroying firm value.

© 2014 Elsevier B.V. All rights reserved.

* Corresponding author at: Accounting, Yonsei University, Republic of Korea. Tel.: +82 2 2123 5484; +82 10 3398 1847.
E-mail address: hylee@yonsei.ac.kr (H.-Y. Lee).

http://dx.doi.org/10.1016/j.pacfin.2014.04.006
0927-538X/© 2014 Elsevier B.V. All rights reserved.

1. Introduction

Related-party transactions (RPTs, hereafter) are defined as transactions with related entities such as shareholders, members of the board of directors, and affiliated companies. Investors and analysts often raise concerns about RPTs, asking whether corporate insiders are fully focused on the interests of shareholders when conducting such transactions (e.g., Wall Street Journal, 2003, B6[1]). RPTs have also become a central issue in more advanced capital markets, creating concerns among regulators and other market participants regarding the appropriate monitoring and auditing of these transactions (Johnson et al., 2000). Extant academic studies provide inconsistent evidence on the effect of RPTs on firm value. Some argue that RPTs can be used as efficient contracting mechanisms under incomplete information achieving shareholder value maximization by reducing transaction costs and thereby achieving economies of scale (Williamson, 1975; Stein, 1997; Khanna and Palepu, 1997) (efficient transaction hypothesis), while others argue that RPTs destroy firm value because they arise from conflicts of interests between controlling shareholders and minority shareholders and are carried out in the interest of controlling shareholders to expropriate wealth from minority shareholders (Shin and Park, 1999; Chang and Hong, 2000; Johnson et al., 2000) (conflict of interest hypothesis). These opposite and conflicting predictions and findings in prior literature may be attributed to a failure to examine the role of the agency problem in relation between RPTs and firm value.

Concentrated ownership often leads to a divergence of control rights (or voting rights) and cash flow rights, commonly referred to as the “control–ownership wedge,” or more simply the “wedge.” A high control–ownership wedge may provide controlling shareholders, who typically have voting rights in excess of cash flow rights, incentives to extract private benefits at the expense of minority shareholders. Consistent with this notion, recent studies document that firm value decreases as corporate insiders control more voting rights relative to their cash flow rights (Claessens et al., 2002; Lemmon and Lins, 2003; Lins, 2003; Harvey et al., 2004; Gompers et al., 2010). In this study, by employing the control–ownership wedge as a proxy of firm-level agency problem, we first predict a positive association between the control–ownership wedge and RPTs indicating that related party transactions are used as a mechanism for tunneling among firms belonging to large business groups in Korea (chaebols). We further predict that the positive association between the wedge and RPTs is more/less pronounced depending on the type of RPTs and size of the chaebol. Next, we predict a negative association between RPTs and firm value consistent with the idea that RPTs are potential channels through which this specific ownership structure leads to firm value destruction. We further predict that the negative effect of RPTs on firm value is more pronounced when the control–ownership wedge is large and more so for the top 5 chaebols than for the non-top 5 chaebols.

The Korean market has several characteristics that make it particularly suited to our investigation. Many Korean listed firms belong to business groups (conglomerates) known as chaebol which links their affiliated firms via cross and/or circular-shareholdings (Kim and Yi, 2006). As a result, Korean firms are likely to have a large disparity between voting rights and cash flow rights, which makes the effect of the control–ownership wedge more apparent. The divergence between ownership and control rights in the Korean market implies that the agency conflicts between controlling shareholders and minority shareholders are severe. This ownership structure suggests that the expropriation of minority shareholder wealth is a distinct possibility. Korea also has relatively weak protections for outside minority shareholders (La Porta et al., 1999; Bae et al., 2002). Thus, the effect of the disparity is likely to be more apparent in Korea than other countries. Lastly, Korean chaebol firms are likely to exercise more transactions with related parties than those in other countries because horizontal diversification across different industries is more common. Altogether, the Korean setting provides a more powerful means for examining the association between the wedge and RPTs than any other country.

[1] “These are the kinds of relationships that companies should avoid, in the view of some corporate-governance experts and investors. Such related-party transactions raise questions about whether corporate insiders are fully focused on the interests of shareholders, experts say. The deals, no matter how small, can create the impression that an insider is using company assets for personal benefit, and that the company is getting the short end of the stick.” (Wall Street Journal, 2003, “Even Good Insider Deals Raise Doubts”, B6).

Download English Version:

https://daneshyari.com/en/article/973602

Download Persian Version:

https://daneshyari.com/article/973602

Daneshyari.com