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Iuliana Oana MIHAI*, Riana Iren RADU, Violeta ISAI

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Corporate Governance and Related Parties Transactions - Evidence from Romanian Listed Companies

Iuliana Oana MIHAI^{1*}, Riana Iren RADU², Violeta ISAI³

Abstract

The objective of this work is to offer contributions to improve the understanding of related party transactions. Our goal is to explore the role of related party transactions from the perspective of company's corporate governance environment. Even though there is a growing interest in related party transactions, there is little academic literature to understand the nature of related party transactions and their economic consequences. Our study was conducted on a sample of 40 companies listed on Bucharest Stock Exchange activating in manufacturing sector. Our objective was to analyse the way the companies follow the requirements of transparency of related party transaction. Based on our observations on companies' financial reports and companies websites, the level of transparency between these companies was reflected by an index estimated from producers' scores on Likert-type scales (one to five) that showed to what extent they disclose or not disclose information such as relationship between parents and subsidiaries, key management personnel compensation, the value of transactions with related parties or separate disclosure for the group entities.

Keywords: *related party, corporate governance, financial reports.*

1. Introduction

In the academic and business literature we can find two alternative views of related party transactions which are consistent with economic theory. These are conflict of interest view and efficient transactions view.

¹ "Dunarea de Jos" University of Galati, Romania, oana.anghel@ugal.ro

² "Dunarea de Jos" University of Galati, Romania, raduriana@gmail.com

³ "Dunarea de Jos" University of Galati, Romania, violeta.isai@yahoo.com.

* Corresponding author



According to conflict of interest view, related party transactions would compromise management's agency responsibility to shareholders or the board of director's monitoring function. According to efficient transactions view, related party transactions satisfy the economic needs of company between parties who have built up trust and shared private information [5]. In other word, related party transactions can be harmful for shareholders or can be no harmful to them or even beneficial. The conflict of interest view is derived from agency theory while the efficient transactions view is derived from transaction cost theory. These two opposite views have significantly different implications for corporate governance [8]. The mechanism of corporate governance would be associated with related party transactions (positively or negatively) or would be needless in respect with related party transactions.

2. Problem Statement

In the last years, corporate governance has achieved importance around the world. Romanian regulators also survey corporate governance developments around the world and occasionally introduce some of the best practices followed or introduced in other countries. The listing agreement includes several mandatory governance regulations and disclosures for listed companies in Bucharest stock exchanges. The issue of investor protection, in particular the minority shareholder has drawn the attention of both academics and regulators.

Majority shareholders or managers often rely on different forms of transactions such as excessive benefits or bonuses, transfer pricing, corporate opportunity allocation, and self-managed financial transactions such as the issue of targeted shares or loans to insiders and corporate misappropriation of company goods.

Regulatory authorities around the world have taken steps to monitor and prevent such situations like transparency and reporting rules, approval, or direct prohibition of such transactions.

OECD has also issued a series of guidelines on legislative and regulatory approaches for monitoring and preventing abusive related party [9].

Reporting the entity's transactions, settlement balances and related party relationships are important to the investor. This will allow the investor to effectively assess the entity's financial statements and financial statements, including the risk and opportunity assessments of the entity.

In Romania, the market value principle was introduced into tax legislation in 1994 and is applicable to all transactions with related parties

including those between a foreign companies and their permanent establishment in Romania. Starting with 2010, transactions conducted between affiliated or related Romanian companies also fall within the scope of the transfer pricing rules. Previously only transactions conducted between Romanian entities and non-resident affiliated parties could be verified.

Romanian fiscal code establishes general rules for transactions between affiliated parties. These transactions must be carried out according to the free market price principle, which means the conditions imposed must not be different from commercial or financial relationships established between independent companies.

The profits of affiliated parts must be determined according to transfer pricing principles. If comparability differences are found and the taxpayer cannot explain such differences and it is concluded that the transfer costs are not set at arm length, the tax authority is entitled to adjust the amount of revenue and expenditure so that the market value is reflected. Presently, this statement applies to both domestic and cross-border transactions.

Related party transactions in international accounting standards

The international accounting bodies replied quickly to the need for disclosure of related party information. For example, the international accounting referential has issued a special standard, IAS 24 "Disclosure of Related Party Transactions", which contains provisions regarding the identification of related parties, transactions with them and the resulting balances, as well as the circumstances in which disclosure is required in the financial statements [2].

The International Accounting Standards Board (IASB) defines related party transactions as a transfer of resources, services, or obligations between related parties regardless of whether a price is charged, while the Financial Accounting Standards Board (FASB) defines it as a transaction between related parties even though it may not be given accounting recognition; for example, one entity may receive services from a second, related entity without charge and without recording a receipt of services.

IAS 24 requires that transactions between entities that are considered related parties to be disclosed in company financial statements. In present, most countries have imposed similar obligations. The justification for such disclosures is the concern that related companies usually have the power to set the prices to be charged and on other transaction terms. Also, the company needs to disclose related party transactions because the users of financial information need to understand what part of commercial and other

activity is carry out by the entity and third parties and to what extent the reporting entity is reliant on its related parties. Thus, in order to ensure transparency, reporting entities are required to disclose the nature, type, and components of transactions with related parties (IAS 24)

According to IAS 24 “related-party relationships are a normal feature of commerce and business” but could have an impact on the financial position of the company, due to the possibility that transactions with related parties may not be realised for the same amounts or terms as are those between independent parties. For this motive, extensive disclosure rules of these transactions are necessary in order to deliver a fair image of the financial position and performance

While IAS 24 has been operative for over two decades, it is commonly observed that related-party transactions are not being properly disclosed in all instances. This is due in part, perhaps, to the perceived sensitive nature of such disclosures and fear of giving out too much information that may be detrimental to the reporting entity. As a consequence, even when a note to financial statements that is captioned “related-party transactions” is presented; it is often fairly evident that the spectrum of disclosures required by IAS 24 has not been included. There seems to be particular resistance to reporting certain types of related-party transactions, such as loans to directors, key management personnel, or close members of the executives’ families.

Corporate Governance and Related Party Transactions

Corporate governance is considered the best solution in order to control the conflict of interest between different stakeholders. The concept of corporate governance refers to the set of mechanisms that influence the decisions made by managers when there is a separation of ownership and control. Directors, owners and corporate managers have started to realize the benefits of having a good corporate governance structures. One important benefit of good corporate governance is that capital can be obtained much easier. International investors hesitate to lend money or buy shares in a corporation that does not subscribe to good corporate governance principles. Transparency, independent directors and a separate audit committee are especially important for international investors and they will not invest in a company that does not have these things[7].

The concept of corporate governance emerged in Romania only in the early 2000s. The primary sources of law related to corporate governance are: the company law, capital market law, capital market law, the law of

insolvency, the law of accounting, the order of minister of public finance regarding the accounting rules.

The explicit corporate governance requirements for Romanian listed companies can be found in the new "Corporate Governance Code" issued by the Bucharest Stock Exchange. The Corporate Governance Code (CGC) issued by the Bucharest Stock Exchange was last updated in 2008 and includes supplementary requirements to the legal obligations included in Romanian legislation.

This code is based on OCDE principles of corporate governance and became applicable for Romanian listed companies starting from 2009. The code is applied on voluntary basis by the companies traded on the regulated market of BSE. Companies that decide to adopt the code, either partially or entirely are required to annually submit a standardized statement, the "Apply or Explain Statement". In this statement, issuers are required to specify the compliance or non-compliance with the Code, which recommendations of the code have been implemented. If a recommendation has not been implemented, the issuers are required to explain the reasons.

In Romania companies are generally characterized by the corporate governance model based on internal control and management employees, but with certain conditions based on national economic, social, political, cultural specific forms of governance that have emerged and developed. Corporate governance trend of Romanian companies and their performance must be analysed in the context of transition from planned to market economy. The main methods of privatization that caused the emergence of private sector in Romania were MEBO, mass privatization program and selling stakes to investors across companies [5].

According to OECD report Romania has the following types of government business as a result of the privatization process: state-owned companies, close private firms

State-owned companies or incompletely privatized companies, the state is still a shareholder. Within these companies there is a predictably conflict of interest between managers, employees and the state, resulting in conflicting objectives: maximizing profits, maintain jobs, increase tax revenues, satisfy political or individual interests. Economic performance is not the major objective of these economic entities, interests the directors of these companies are rarely subordinated to the interests of shareholders.

In the case of closed private firms (small, medium or large), whose shares are not traded on an official market. Owners are usually managers, so there is no conflict of interests between them. However there are many conflicts between owners also resulting in lawsuits. Managers do not aim to

maximize the value of the company priority, but rather expanding the business.

According to OECD reports the major problem for Romanian corporate sector is the conflict between majority shareholders and minority shareholders, which also generate in conflicts between management and shareholders. This conflict has consequences the deterioration of companies' long term performance and even the bankruptcy of the company. There are five categories of shareholders that control companies listed on BSE: strategic investors, the employees associations, institutional investors, the state and natural persons.

According to the OECD report the major problem of corporate governance for Romanian companies is the board of directors. The board of directors is not efficient in reducing managerial entrenchment and it even contributes to making the problem more serious. There are three main reasons the OECD report mentions. The first is the structure of the board which allows for members of the executive team to be part of the board and even become its president. The second is the legal framework related to board member nomination. Finally, the report mentions a general passive attitude of state nominated board members accompanied by little use of specialized committees and scarcity of independent board members which allows management to assume broader responsibilities and to intervene in board decisions. The same report points out a low equity culture and small shareholder activism and suggests informing and assisting companies and investors in organizing proxy voting which, while legally possible, is rarely used. Managerial compensation based on company' performance is not a common practice in Romanian. However, considering the high levels of managerial entrenchment reported by the OECD, this practice would arguably have a more self-dealing effect than one of aligning managerial and shareholder goals and therefore cannot be considered a viable corporate governance mechanism. The weak presence of the above mentioned corporate governance mechanisms and the possible damaging effect of the board suggest that ownership concentration is the main feasible monitoring technique on management currently available to shareholders of Romanian companies.

Investor Protections from related-party transactions

As in most jurisdictions, related-party transactions in Romania are governed by a set of rules, regulations, standards intended to ensure that they are conducted in a way that does not abuse the rights of independent shareholders. We are talking about accounting standards, listing rules, which

require the disclosure of financial and nonfinancial information. But at the most important mechanism is internal corporate governance systems led by independent directors who are fair to all shareholders. In certain situations, minority shareholders and third-party advisers may also get involved in decisions on related-party transactions. Above all, these are corporate laws that sometimes set the boundaries for related transactions but always define the responsibilities of management and the fiduciary duty of the board of directors. A key element of investor protection against related-party abuses is the investor's opportunity to take directors to court through shareholder suits to seek remedy for corporate misdeeds.

Apart from accounting standards and listing-rule requirements, companies' internal governance systems concerning related-party transactions are essential investor protection mechanisms. One line of defence lies with companies' policies and procedures for monitoring the transactions [6].

In some countries the rules are more strictness. For example in India, companies are required to maintain a register of all related-party transactions that is open to inspection by shareholders. In China, companies are required to have a separate management committee tasked with reviewing related-party transactions. Another way of protection lies with directors' approval of these transactions. That means independent non-executive directors and audit committees. They play a crucial role in determining the fairness of related transactions to minority shareholders. For this reason, regulators in most Europe require listed companies to have a minimum number of independent nonexecutive directors, as well as an audit committee with independent members.

In Korea, for example, the listing rules require that companies have at least one-fourth and no fewer than three of its board of directors be independent, whereas the commercial law requires two-thirds of the audit committee (which should have at least three members) to also be independent. In Hong Kong, the listing rules require companies to have at least three independent directors; audit committees must have only non-executive directors (at least one of whom must be independent) with appropriate professional qualifications or accounting or financial-management expertise. In China, the corporate governance code requires one-third of the board to be independent. A majority of the members of the audit committee (including its chair) must also be independent, and one of them must be an accounting professional.

3. Aims of the research

Our study was conducted on a sample formed by manufacturing listed companies on Bucharest Stock Exchange. Financial companies were excluded because these are subject to different regulatory constraints and are exempted from the sample. The data were manually collected from the annual reports published by the companies on their website or on the website of Bucharest Stock exchange. Also some information was collected from Amadeus data base. We restricted our sample to those active companies with total assets of minimum 8000000 €, sales turnover of minimum 4000000 € and number of employees more than 50. The final sample consisted in 40 companies.

We were interested of the way the companies follow the requirements of transparency of related party transaction. Some companies in the sample declare that have no related parts and in consequence do not report transactions with related parts, other companies.

4. Research Methods

Based on our observations on companies' financial reports and companies web-sites, the level of transparency between these companies was reflected by an index estimated from producers' scores on Likert-type scales (one to five) that showed to what extent they disclose or not disclose information such as relationship between parents and subsidiaries, key management personnel compensation, the value of transactions with related parties or separate disclosure for the group entities. For example, companies that disclose very detailed information scored five, while those that do not disclose any information scored one.

For every company in the sample we captured on a five point Likert scale ranging from "provides very detailed information" to "provide no information" (5 - Provides very detailed information, provides many information, Shows brief information, Few information, Does not provide information). An index of the level of transparency observed for each company was then estimated by taking the average score over five questions that related to aspects of related party transactions. For example, if a company scored a 5, 4, 4, 5 and 5 for the five questions, the company scored 4.4 on the level of transparency index. Estimated transparency scores for companies ranged from 1 to 5, with a mean score of 3.10 for the sample. Index values above 4.5 would indicate high levels of transparency, while

values below 1.5 would suggest low levels of transparency regarding the disclosure of related party transactions.

Table 1 – The structure of raw data

No .	Company	Questions				
		Q1	Q2	Q3	Q4	Q5
1	ALRO S.A.	5	5	4	4	5
2	ARMĂȚURA S.A.	5	5	5	3	5
3	BOROMIR PROD S.A.	5	5	5	5	5
....
33	STIROM S.A.	5	5	1	1	1
34	TERAPLAST S.A.	5	5	5	5	5
35	VES S.A.	5	5	5	5	5
36	VRANCART S.A.	5	5	5	5	5

5. Findings

We used as corporate governance variables BvD Independence, an indicator that classifies companies based on the level of ownership concentration. Based on this independence indicator we identify two main groups of companies: Group 1 – companies with B independence indicator – companies with a known recorded shareholder - none of which with an ownership percentage over 50%, but having one or more shareholders with an ownership percentage above 25% and group 2 – companies with D independence indicator - companies with a recorded shareholder with a direct ownership of over 50%.

For formulating the questions we started from the requirements of IAS 24 “Related party disclosure” in order to assess the transparency degree. Our analysis focused on next elements:

Q1 - Disclosure of relationship between parents and subsidiaries (name, location, percentage of control direct and indirect, date)

Q 2 - Disclosure of key management personnel compensation (short – term employee benefits, post-employment benefits, other long term benefits, share-based payments)

Q 3 - Disclosure of related party transactions (nature of relationship, information about transactions,

Q 4 – Disclosure of information about transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements).

Q 5 - Separate disclosure for the following entities (parent, entities with joint control, subsidiaries, associates, joint ventures in which the entity is a joint venture.

Table 2 – Descriptive statistics

	N	Min	Max.	Mean	Std. Deviation
Operating revenues (th. Euro)	36	1357	2.134.000	108.552	359.316
Number of employees	36	16	2397	627,86	547,3
Number of directors, managers, contacts	36	3	23	14,22	4,63
Number of companies in corporate group	36	0	394	21,22	66,123
BvDIndepIndic	36	1	2	1,58	0,5
Q1	35	1	4	2,46	0,92
Q2	36	1	4	2,86	0,72
Q3	36	4	5	4,78	0,42
Q4	36	1	5	4,56	0,81
Q5	36	3	5	4,39	0,55
Valid N (listwise)	35				

Of course the appreciation could be subjective, but in order to eliminate de subjectivism we all preceded individually the same steps for every company.

From the descriptive statistics we can say that in general the listed companies have a high score of transparency with respect to disclosure of information about transactions with related parties, disclosure of information about transactions and outstanding balances and separate disclosure for the following entities. On the other part the transparency degree is much lower in confront with details regarding the disclosure of name, location, percentage of control direct and indirect, date of acquisitions. Also the disclosure degree for key management personnel compensation is low. The listed companies in general disclose general aggregated information regarding the key management personnel compensations. Very few companies disclose detailed information of this issue.

6. Conclusion and Recommendations

Related-party transactions are continuous corporate governance risk in Romania. Although the concept is identical to its meaning in the Western Europe, the practice differs as a result of the ownership structure characteristic to the region. Many companies are majority owned by families or the state and because there is often no separation of ownership and control, related-party transactions are disposed to misuse by families for their private interests or the state for its own agenda.

Beyond the accounting definition of related-party transactions, disputes between members of controlling families also pose harm to the management of publicly listed entities and threaten shareholder value. Abusive related-party transactions happen in Romania because of the weaknesses in the mechanisms that govern them. Independent non-executive directors are in the minority on Romanian boards.

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