

## The Moderating Effects of Independent Directors' Human Capital on the Relationship between Related Party Transactions and Firm Performance: Evidence from Malaysia

*(Kesan Pemoderat Modal Insan Pengarah Bebas ke Atas Hubungan di Antara Urus Niaga Pihak Berkaitan dan Prestasi Firma: Bukti dari Malaysia)*

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### ABSTRACT

*The purpose of this study is to examine the effect of related party transactions (RPTs) on firm performance and whether this effect is moderated by independent directors' (INEDs) presence and their human capital (i.e. functional and firm-specific knowledge). Based on a sample of 300 non-financial firms listed on Bursa Malaysia for 2013, this study found that RPTs in general, have a positive effect on firm performance and this effect varies according to the parties involved in RPTs. Specifically, this study found that firm performance is higher for RPTs involving subsidiaries, associates and joint ventures. The findings support the efficient transactions hypothesis that RPTs can create value to the firm. INEDs' presence and INEDs' functional and firm-specific knowledge are found not to have any moderating effects on the RPTs-firm performance relationship. Therefore, the agency, resource dependence and human capital theories that stress on the importance of INEDs as corporate monitor and advisor are not supported. This study, perhaps the first, explains the interaction effects of INEDs' functional and firm-specific knowledge on RPTs-firm performance relationship.*

*Keywords: Related party transactions; independent directors; human capital; functional knowledge; firm-specific knowledge*

### ABSTRAK

*Tujuan kajian ini adalah untuk mengkaji kesan urus niaga pihak berkaitan (UPB) ke atas prestasi firma dan sama ada kesan tersebut disederhanakan oleh kehadiran pengarah bebas (PB) dan modal insan mereka (iaitu pengetahuan fungsian dan pengetahuan khusus berkaitan firma). Berdasarkan sampel berjumlah 300 buah syarikat bukan kewangan yang tersenarai di Bursa Malaysia dalam tahun 2013, kajian ini mendapati UPB secara amnya mempunyai kesan positif terhadap prestasi firma dan kesan ini berbeza bergantung kepada pihak yang terlibat dalam UPB. Secara khususnya, kajian ini mendapati prestasi firma lebih tinggi bagi UPB yang melibatkan anak syarikat, syarikat bersekutu dan usahasama. Penemuan kajian ini menyokong hipotesis urus niaga efisien bahawa UPB dapat mencipta nilai kepada firma. Kehadiran PB serta pengetahuan fungsian dan khusus berkaitan firma yang dimiliki oleh PB didapati tidak memberi kesan pemoderat ke atas hubungan UPB-prestasi firma. Oleh yang demikian, teori agensi, pergantungan sumber dan modal insan yang menekankan kepentingan PB sebagai pemantau korporat dan penasihat tidak disokong. Kajian ini, mungkin yang pertama, menerangkan kesan interaksi pengetahuan fungsian dan khusus berkaitan firma oleh PB ke atas hubungan UPB-prestasi firma.*

*Kata kunci: Urus niaga pihak berkaitan; pengarah bebas; modal insan; pengetahuan fungsian; pengetahuan khusus berkaitan firma*

### INTRODUCTION

Related party transactions (RPTs) have been highlighted as one of the contributing factors in numerous accounting scandals which include Enron Corporation (USA), Satyam Computers Ltd (India), Asia Pulp and Paper (Indonesia), Transmile Group Berhad (Malaysia), and many others. This indicates that RPTs can be used by insiders (i.e. management and controlling shareholders) as a tool for firm expropriation (Gordon, Henry & Palia 2004; Johnson et al. 2000; Munir et al. 2013). Others, however, argue that not all RPTs are harmful (Cheung et al. 2009; Gordon et

al. 2004; Ryngaert & Thomas 2012), as these transactions can serve various economic and business needs of the firms especially in countries with imperfect markets. For instance, RPTs can be used to optimize internal resource allocation, improve return on assets and minimise costs of transaction (Ge et al. 2010).

Weak governance and monitoring mechanisms have been cited as the cause of many abusive RPTs (Kohlbeck & Mayhew 2010; OECD 2009). This situation provides an opportunity for insiders to divert corporate resources at the least cost to them. Therefore, effective curbing and monitoring of RPTs has come to the forefront of corporate

governance reforms in many countries around the globe (OECD 2009). It is argued that firms with higher quality of corporate governance increase the cost of diversion to the insiders and hence limit their abilities to be involved in the expropriation activities (Dahya, Damitrov & McConnell 2008). INEDs, who have no pecuniary relationship with firm or related persons, are seen as an effective mechanism for reducing the expropriation of minority shareholders (OECD 2009). As a consequence, rules and guidelines relating to INEDs have been reinforced in many jurisdictions.

In Malaysia, the concept of INEDs has received substantial attention from regulators, particularly after the 1997/1998 Asian financial crisis. Numerous initiatives have been taken by Malaysian government to strengthen the role of INEDs. For instance, the requirement for the board of directors of Malaysian public listed companies to consist of INEDs is clearly stated in the Malaysia Code on Corporate Governance (MCCG) and Bursa Malaysia Listing Requirements (BMLR). The MCCG 2000 recommends that as a best practice, the board should include a balance member with at least one third of the membership of the board should comprise INEDs. Furthermore, the MCCG 2012 which supersedes the 2007 Code, introduces certain improvements aimed at reinforcing the independence of INEDs. The Code emphasizes that the board should review the independence of its INEDs annually and INEDs' tenure should be capped at 9 years.

Many studies have been conducted to understand the governance role of INEDs in monitoring management and controlling shareholders activities including transactions with related parties (Abdul Wahab et al. 2011; Dahya et al. 2008; Hasnan, Daie & Hussain 2016). These studies which mostly premised their work on agency theory, have focused mainly on INEDs' presence (measured either by a number of INEDs or the proportion of INEDs). Based on the agency theory, the researchers implicitly assume that firms with higher number or higher proportion of INEDs are more knowledgeable and competent (Kor & Sundaramurthy 2009), and hence are more effective than inside directors in monitoring the insiders (Fama & Jensen 1983). These studies, however, yielded inconclusive results. The emerging theoretical work on board capital argues that a gap may exist between what INEDs are expected to achieve and the ability in the form of knowledge, skill and experience they possess (Chen, Chang & Hsu 2017; Khanna, Jones & Boivie 2014; Kor & Sundaramurthy 2009; Tian, Haleblian & Rajagopalan 2011). Therefore, proponents of board capital perspective call for future studies to incorporate the directors' human capital when examining board effectiveness (Carpenter & Westphal 2001; Hillman & Dalziel 2003; Khanna et al. 2014). Since limited research has been undertaken on the effects of INEDs' human capital and in response to the above-mentioned knowledge gap, this study using human capital perspective, pay attention to the role of INEDs' human capital on RPTs-firm performance relationship.

Malaysia provides a useful setting to study the above-mentioned issues. As in emerging markets, RPTs are also

a common business deal among Malaysian companies. This situation can be associated with the economy of Malaysia which is characterised by a relationship-based system. In addition, the ownership structure of Malaysian companies is highly concentrated where families and the government owns significant equity ownership in many listed companies. Therefore, it is not surprising that economic transactions of many Malaysian companies tend to be based on connections. Moreover, a substantial number of Malaysian listed companies belong to large business groups where members are bound together by formal and/or informal ties. Such a structure may result in the widespread use of RPTs.

This study contributes to the existing literature in two ways. First, this study adds to the literature on RPTs by examining whether different types of parties affect firm performance differently. By distinguishing RPTs into transactions with related entities and transactions with related persons, the findings from this study can provide further understanding regarding RPTs practices in Malaysia. Secondly, this study extends prior research on the role of INEDs which tend to focus more on INEDs' presence (generally used as a proxy of board independence), rather than on the ability that they possess. The inclusion of INEDs' human capital variables is consistent with the argument put forward by the proponents of board capital perspective that for INEDs to perform their monitoring and advising role effectively, they must have sufficient ability in the form of skills, experience and knowledge (Hillman & Dalziel 2003; Kor & Sundaramurthy 2009; Tian et al. 2011). Therefore, findings from this study will provide better understanding on how INEDs' human capital (i.e. INEDs' functional and firm-specific knowledge) shapes the ability of INEDs to monitor and offer advice to the insiders on RPTs activities and, consequently the effect of RPTs on firm performance.

This paper is organized as follows. In the next section, some relevant literature relating to RPTs and INEDs is presented. Next, four main hypotheses are developed. Then, the research methodology, which includes sample and data selection, measurement of variables and research models are described. Finally, the results, discussion and conclusion are discussed.

## LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### RELATED PARTY TRANSACTIONS AND FIRM PERFORMANCE

The existing literature suggests that there are both potential costs and benefits related with RPTs.

From the perspective of conflict of interest hypothesis, which is consistent with agency theory, RPTs are considered as a way of expropriating firm's resources and therefore these transactions are viewed as harmful to the interests of shareholders (Ali & Rahmat 2017; Gordon et al. 2004; Johnson et al. 2000). Generally, parties involved

in RPTs are joined by a special relationship prior to the transactions. This special relationship creates potential conflicts of interest which can result in actions that benefit the related parties as opposed to unrelated parties. Thus, RPTs can allow controlling shareholders to profit at the expense of minority shareholders, particularly when monitoring mechanisms to reduce the opportunistic behaviour of the insiders are weak or absent (Kohlbeck & Mayhew 2010).

Expropriation of minority shareholders, or sometimes called “*tunneling*” (Johnson et al. 2000) or “*self-dealing*” phenomenon (Djankov et al. 2008), can take many forms. These include executive perquisites, excessive compensation, advantageous transfer pricing, directed equity issuance, loans at preferential terms, and outright theft of corporate assets (Faccio, Lang & Young 2001; Johnson et al. 2000; Shleifer & Vishny 1997). In addition, anecdotal evidence such as Enron reveals the use of RPTs with special purpose entities by its chief financial officer (CFO) to camouflage debts and create fabricated earnings (Kohlbeck & Mayhew 2010). The involvement of managers or controlling shareholder in RPTs gives them an incentive to take actions that are not in line with shareholder wealth maximization (Fama & Jensen 1983; Jensen & Meckling 1976).

The adverse impact of RPTs has been reported by prior studies. RPTs have been proven to reduce earnings quality (Gordon & Henry 2005; Jian & Wong 2003; Wang & Yan 2012), undermine corporate value (Cheung, Rau & Stouraitis 2006; Gordon et al. 2004) and lead to loss of business opportunity for the listed company (OECD 2009). At their worst, RPTs played a vital role in contributing to corporate collapses, which in turn, have erased billions of dollars of shareholder value and eroded investor confidence in the capital markets (CFA 2009). In sum, the conflict of interest hypothesis postulates that RPTs represent potential conflict of interest which may result in the expropriation of minority shareholders, and accordingly RPTs may have a negative effect on firm performance.

In contrast, the efficient transactions hypothesis suggests that RPTs can be part of efficient contracting arrangements with related parties, particularly in situations with incomplete information (Ryngaert & Thomas 2012). Ryngaert and Thomas (2012) argue that contracts with related parties provide better coordination and feedback between the contracting parties. RPTs may also mitigate holdup problems in the contracting process and facilitate investment in firm-specific relationship. Thus, engaging in RPTs is seen as more effective and cost efficient rather than engaging in similar transactions with unrelated parties. This view is supported by Gordon and Henry (2005) who argued that RPTs fulfill a firm's economic needs and serve as a bonding mechanism that ties the related party to the company. Consequently, it reduces the incentives of managers or controlling shareholders to engage in risk taking behavior that might jeopardize the firm or the related party's relationship with the firm.

However, empirical evidence supporting beneficial RPTs is limited. Khanna and Palepu (2000) find that firms affiliated with business group perform better than non-affiliated firms, suggesting that transactions within business groups could assist affiliated firms in better allocation of resources. Friedman, Johnson and Mitton (2003), Peng, Wei and Yang (2011) and Riyanto and Toolsema (2008) show that RPTs can be used by controlling shareholders to prop up financially distressed firm or to save the receiving firm from bankruptcy. Furthermore, Peng et al. (2011) show that markets react favourably to the announcement of RPTs when the firm is in financial difficulty. Therefore, from the perspective of efficient transactions hypothesis, RPTs benefits shareholders and may have a positive effect on firm outcomes.

Referring to studies conducted in Malaysia, Abdul Wahab et al (2011), Hasnan et al. (2016) and Munir et al. (2013) provide evidence that support the conflict of interest perspective, suggesting that in Malaysia, RPTs provide channels for controlling shareholders to extract corporate resources from minority shareholders, and therefore negatively affect firm performance. The expropriation of minority shareholders via RPTs in Malaysia is more likely to occur due to the dominant presence of family ownership, nature of capital market that is labelled as relationship-based economy and weak enforcement and protection of minority shareholders (Abdul Wahab et al. 2011; Munir et al. 2013). Consistent with prior research and conflict of interest view, this study argues that in general, RPTs are likely to have a negative effect on firm performance. Based on the above discussion, this paper posits the following hypothesis:

H<sub>1</sub> There is a negative relationship between RPTs and firm performance.

Ryngaert and Thomas (2012) argue that not all RPTs are abusive. RPTs may be either potentially beneficial or potentially harmful to shareholders depending on types of RPTs or types of parties involved in RPTs (Gordon et al. 2004; Kohlbeck & Mayhew 2010; Nekhili & Cherif 2011). This study extends prior research by distinguishing RPTs according to types of related parties. Consistent with MFRS 124 Related Party Disclosures, Chapter 10 of the BMLR and in line with study by Nekhili and Cherif (2011), RPTs are classified into two major categories; (a) RPTs with related entities and, (b) RPTs with related persons. Transactions with related entities include transactions involving subsidiaries, associates and joint ventures, while transactions with related persons include transactions involving directors, major shareholders, person connected with director or major shareholders or director related entities.

In the literature, transactions involving subsidiaries, associates and joint ventures are not always conducted to violate minority shareholders rights (Khanna & Palepu 2000; Nekhili & Cherif 2011). The presence of business group and the informal nature of business relationships are among factors that facilitate RPTs. Some scholars

characterize business groups as “*paragons*” that help firms to overcome market failures, especially in difficult economic and institutional conditions (Khanna & Yafeh 2007). It has been argued that intra-group transactions between the group and subsidiaries, associates and joint ventures would help in reducing transaction costs and overcoming difficulties in enforcing property rights and contracts essential for production (Chen, Chen & Chen 2009; Cheung et al. 2009; Khanna & Palepu 2000; Kim 2004). RPTs among member firms also involve less information asymmetry than similar transactions with unrelated party (Kohlbeck & Mayhew 2010). Furthermore, such dealings are perceived as being inevitable, useful and recurring in ongoing operations (OECD 2009).

In contrast, transactions with directors, major shareholders, and person connected with directors or major shareholders or director related entities are argued to potentially result in the expropriation of minority shareholders (Nekhili & Cherif 2011). These parties have been identified to play a major role in many accounting scandals. For example, former CEO and executive director in Transmile Group Bhd were charged by the court for their responsibility for a false and misleading financial statements resulted from unusual RPTs created to window dress its financial statements (Hamid et al. 2013).

Corporate Governance Guide (CGG) 2013 highlights that transactions with related persons may give rise to conflict of interest when parties involved in these transactions have the ability to influence firm’s decision making, which in turn lead to personal gain. Nekhili and Cherif (2011) provide evidence that transactions directly made with related persons negatively affect firm value. The findings are consistent with Kohlbeck and Mayhew (2010), who find that market assigns lower value to firms engaging in RPTs with directors, officers and major shareholders. Based on the above discussion, this paper posits the following hypothesis:

- H<sub>1a</sub> There is a positive relationship between RPTs with related entities (i.e. transactions with subsidiaries, associates and joint ventures) and firm performance.
- H<sub>1b</sub> There is a negative relationship between RPTs with related persons (i.e. transactions with directors, substantial shareholder, and person connected with directors or substantial shareholder or director related entities) and firm performance.

#### MODERATING EFFECT OF INDEPENDENT DIRECTORS’ PRESENCE

Following the Asian financial crisis of 1997/1998 and prior corporate scandals, INEDS became a central concern in many regulatory and governance reforms around the world. For instance, the Sarbanes-Oxley Act of 2002 (SOX) was enacted to strengthen the independence of the U.S publicly traded company’s directors. In Malaysia, the structure of corporate governance and listing requirements

have been reformed and amended, which among other to curb abusive RPTs and to strengthen the role of INEDS. For example, the MCGG 2000 and 2007, recognize the importance of board independence by requiring at least one-third of the boards to comprise INEDS. Furthermore, the MCGG 2012 highlights the need for a board to have policies and procedures to ensure effectiveness of INEDS. Therefore, the board should carry out an annual assessment of the independence of its INEDS.

The role of INEDS in monitoring RPTs has been addressed in CGG 2013. The Guide highlights that “*an independent director is especially important in areas where the interests of management, the company, the shareholders and other stakeholders diverge, such as executive performance and remuneration, related party transactions, environmental issues and audit*” (CGG 2013: 20). This role is consistent with the argument in agency theory. The agency theory argues that INEDS, being independent from the influence of management and controlling shareholders, are expected to effectively monitor controlling insiders and hence can protect shareholders against insiders’ opportunism (Fama 1980; Fama & Jensen 1983). In concentrated ownership structure, because the interests of controlling shareholders are not aligned with minority shareholders, the appointment of outside (or independent) directors, as opposed to inside directors are viewed by minority shareholders as objective monitors of the firm (Kim, Kitsabunnarat-Chatjuthamard & Nofsinger 2007). With respect to RPTs, board approval is the primary method in protecting minority shareholders (OECD 2012). In the board approval process, INEDS play a crucial role in reviewing and approving the terms and conditions of RPTs to prevent abuse (OECD 2012). As a guardian of minority shareholders, there is an expectation that INEDS scrutinise proposed RPTs undertaken by a firm so as to ensure that the transactions are fair, reasonable and are in the best interest of all shareholders. Effective monitoring by INEDS could raise the cost of diversion to the controlling shareholders and thereby reduce the ability of the controlling shareholders to divert corporate resources (Dahya et al. 2008).

Numerous studies have been conducted to examine the role of INEDS in monitoring RPTs, but with conflicting results. Some studies provide evidence that having more INEDS will reduce the expropriation of minority shareholders through RPTs and hence increase firm performance. For instance, using data from 22 countries, Dahya et al. (2008) found a significant negative relationship between the proportion of INEDS and RPTs which indicate that firms with a higher percentage of INEDS are less likely to engage in RPTs. Similar results are found in Australia (Gallery, Gallery & Supranowicz 2008), China (Lo, Wong & Firth 2010) and Indonesia (Utama & Utama 2014). There are also a few studies on the moderating effect of INEDS on RPTs-firm performance relationship that support the importance of INEDS. Abdul Wahab et al. (2011) and Chien and Hsu (2010) show that INEDS can play a monitoring role and thus reduce the negative effect of

RPTs on firm performance. Their results suggest that good corporate governance mechanisms can transfer RPTs from “*conflict of interest*” to “*efficient transactions*,” which in turn increases firm performance.

There are also countering arguments on the role of INEDs as corporate monitor. Kim (2007) and Peng (2004) argue that INEDs may be appointed due to external institutional pressure and therefore do not necessarily increase efficiency. In countries with concentrated ownership structure, there is a tendency that controlling shareholders can exert significant influence on the selection of INEDs (Abdullah et al. 2016). The candidates for INEDs normally are those within the personal network of the insiders. This personal network or social ties between INEDs and the controlling shareholders are argued to impair the independence of INEDs (Abdullah et al. 2016; Lin 2013) and hence undermine the ability of INEDs to minimise abusive RPTs (Khosa 2017). Khosa (2017) provides evidence that due to self-control problem of family firms in India, INEDs are less likely to be effective monitor and, therefore, their presence is valued negatively by the market.

In sum, prior studies provide mixed results on the monitoring role of INEDs. However, consistent with the argument put forward by the agency theory, this study predicts that the presence of higher number of INEDs would result in better monitoring of RPTs. Board dominated by INEDs is less constrained in questioning or disagreeing with management (CGG 2013) and therefore can reduce the threat of wealth transfers to the controlling shareholders by restraining RPTs that damage firm performance (Dahya et al. 2008). Furthermore, with more stringent rules, regulations and guidelines in Malaysia aimed to enhance board independence, it is believed that these could further empower INEDs to act as an effective “*check and balance*” on management and controlling shareholders. It is suggested that effective monitoring by INEDs could result in better allocation of firm's resources via RPTs and therefore the presence of INEDs could moderate the effect of RPTs on firm performance. Based on the above discussion, this paper posits the following hypothesis:

- H<sub>2</sub> INEDs' presence will weaken the negative relationship between RPTs and firm performance
- H<sub>2a</sub> INEDs' presence will strengthen the positive relationship between RPTs with related entities and firm performance
- H<sub>2b</sub> INEDs' presence will weaken the negative relationship between RPTs with related persons and firm performance

#### MODERATING EFFECTS OF INDEPENDENT DIRECTORS' HUMAN CAPITAL

Agency theory posits that INEDs, because of their independence, have more incentive than inside directors to monitor managers and controlling shareholders (Fama & Jensen 1983). However, proponents of board

capital perspective argue that relying solely on directors' independence may not be sufficient condition for directors' effectiveness (Hillman & Dalziel 2003; Kroll, Walter & Wright 2008). For INEDs to perform their role effectively, they must have sufficient ability (Hillman & Dalziel 2003; Tian et al. 2011). This ability refers to board's capital where human capital is one of the critical resources that INEDs bring into the firm (Hillman & Dalziel 2003; Khanna et al. 2014; Kor & Sundaramurthy 2009). Since the contributions of INEDs to the boards may vary based on their unique human capital (Kor & Sundaramurthy 2009), many recent researchers suggest for future studies to incorporate INEDs' human capital when examining board effectiveness (Carpenter & Westphal 2001; Hillman & Dalziel 2003; Khanna et al. 2014). Building on resource dependence and human capital theories, board capital scholars argue that INEDs' human capital shapes the ability of INEDs to perform their monitoring and advise-giving roles (Chen 2014; Kor & Sundaramurthy 2009; Hillman & Dalziel 2003). Therefore, integrating INEDs' human capital in addition to INEDs' presence, may provide richer understanding on the ability of INEDs to monitor and advise the insiders on issue pertaining to RPTs, with consequences for firm performance.

In Malaysia, the importance of directors' human capital has been highlighted in MCGG 2000. The Code states that “*non-executive directors (including INEDs) should be persons of calibre, credibility and have the necessary skill and experience to bring an independent judgement to bear on the issues of strategy, performance and resources including key appointments and standards of conduct*” (MCGG 2000: 9). INEDs are appointed because of the resources that they can bring to the boardroom. Thus, INEDs' human capital should be a crucial screening criteria adopted by the nominating committees. The MCGG 2000 also requires the nominating committee to “*annually review its required mix of skills and experience and other qualities, including core competencies which non-executive directors should bring to the board. This should be disclosed in the annual report*” (MCGG 2000: 10).

Human capital refers to the resources that are embedded within individuals (Becker 1962). These resources consist of knowledge and skills developed through investments in education, training, and various experiences (Becker 1962; Hillman & Dalziel 2003). A more broader definition is provided by OECD (2001), where the term human capital is defined as “*the knowledge, skills, competencies and attributes embodied in individuals that facilitate the creation of personal, social and economic well-being*” (OECD 2001: 18). In general, human capital has many dimensions and review of literature indicates that functional and firm-specific knowledge are two dimensions of human capital that play a crucial role in enhancing INEDs' monitoring and advisory roles (Guldiken & Darendali 2016; Kor & Sundaramurthy 2009; Johnson, Schnatterly & Hill 2013). Such knowledge is argued to affect what directors (including INEDs) pay attention to and how they frame decisions (Johnson et al. 2013).

Relying on resource dependence and human capital theories, this study examines the moderating effects of INEDS' functional knowledge in accounting and finance and firm-specific knowledge on the relationship between RPTs and firm performance. This study argues that INEDS who have more functional and firm-specific knowledge are subject to less information asymmetry (Guldiken & Darendali 2016). This is because, equipped with these knowledge provides them with better access to more and higher quality information (Carpenter & Westphal 2001; Tian et al. 2011) which may lead to more effective information processing and decision making ability (Tian et al. 2011). Consequently, INEDS with high level of human capital are argued to better detect insiders' opportunism (Guldiken & Darendali 2016) and therefore can limit RPTs that damage firm performance. In addition, resource-rich INEDS can provide better advice and counsel to managers and controlling shareholders in conducting more efficient RPTs.

#### FUNCTIONAL KNOWLEDGE (PROXIED BY INDEPENDENT DIRECTORS' FINANCIAL EXPERTISE)

Functional knowledge relates to knowledge in finance, accounting, legal, marketing and economics (Hambrick & Manson 1984; Carmeli 2006). Knowledge in accounting and finance has been recognised as one of the important criteria for INEDS to fulfill their monitoring role. Prior research provides evidence that INEDS with functional knowledge in accounting and finance may enhance the quality of financial reporting process, reduce the likelihood of fraud and earnings restatements, more effective in mitigating earnings management and less likely to be associated with the occurrence of internal control problems (Agrawal & Chadha 2005; Carcello et al. 2006; Krishnan 2005). Due to the benefits associated with financial expertise that INEDS bring into a firm, the MCCG 2007 strongly recommended that all members of audit committee comprised of non-executive directors who are financially literate and at least one should be a member of an accounting association or body. This recommendation is mandated in Chapter 15.09 of the BMLR.

With regards to RPTs, one of the important roles of INEDS (being part of an audit committee) is to monitor and to ensure that RPTs are conducted in the best interest of company and its minority shareholders. The details of their duties have been discussed in the CGG 2013 issued by Bursa Malaysia. Among others, they are responsible to review RPTs and conflict of interest situations and ensure that RPTs are fair, reasonable and are not prejudicial to the interests of the company or its minority shareholders. They also need to warrant that a proper and comprehensive framework for the identification, monitoring, evaluating, approving and reporting of RPTs is established.

RPTs are usually made through complicated transactions between the firm and its managers, directors, subsidiaries and major shareholders, making them a

potential platform for insiders' opportunism. Pucek and Richards (2013) argue that many RPTs have "*substance over form*" problems and some of them are embedded in documentation that is less clear or thorough than the documentation that ordinarily exists between unrelated parties. These provide opportunities for insiders to engage in abusive RPTs. Anecdotal evidence shows that RPTs are one of the contributing factors to the numerous accounting failures and fraud. Due to the complicated nature of RPTs, this study therefore suggests that INEDS who have sound knowledge in accounting and finance may be better able to detect any potential risk associated with RPTs. It is expected that INEDS with functional knowledge in accounting and finance are more likely to constrain disadvantages RPTs and this in turn will improve firm performance. The above reasoning leads to the following hypothesis:

- H<sub>3</sub> INEDS with functional knowledge in accounting and finance will weaken the negative relationship between RPTs and firm performance
- H<sub>3a</sub> INEDS with functional knowledge in accounting and finance will strengthen the positive relationship between RPTs with related entities and firm performance
- H<sub>3b</sub> INEDS with functional knowledge in accounting and finance will weaken the negative relationship between RPTs with related person and firm performance

#### FIRM-SPECIFIC KNOWLEDGE (PROXIED BY INDEPENDENT DIRECTORS' TENURE)

Firm-specific knowledge refers to detail information about the firm and an intimate understanding of its operation (Hambrick & Manson 1984). It is argued that INEDS who lack firm-specific knowledge may not have the ability to effectively perform their monitoring and advisory roles (Kor & Sundaramurthy 2009). INEDS are not a full-time directors and not involved in the operational and management aspects of the firm. Thus, it takes time for them to become knowledgeable about the firm (Brown et al. 2017). INEDS develop their firm-specific knowledge over the passage of their tenure. Consequently, INEDS who have served on the boards for an extended period of time can develop firm-specific knowledge, and thereby enable them to provide superior monitoring of the management and controlling shareholders. Equipped with firm-specific knowledge, INEDS can evaluate the activities of controlling shareholders more accurately due their familiarity with the focal firm's resources and capabilities (Guldiken & Darendali 2016; Kor & Sundaramurthy 2009). Furthermore, during serving on a particular board, INEDS can build internal social capital in term of more intimate knowledge and familiarity about top management's skills and personalities. Consequently, they can interpret more accurately the information received from top management. Long tenure can also increase INEDS' familiarity with one another's skills, habits and personalities, thereby enabling

them to function and make decision effectively as a group (Fisher & Pollock 2004; Kor & Sundaramurthy 2009; Westphal & Bednar 2005).

This study argues that INEDs that have high levels of firm-specific knowledge and more familiar with each other are more willing to closely monitor and encourage the controlling shareholders to enter into beneficial RPTs. Recently, the Malaysian regulators have expressed concern about director tenure. The revised MCGG 2012 recommends to limit the services of INEDs to a maximum of nine years with the justification that long tenure may impair their independence. However, this recommendation is contradict with the argument of the resource dependence and human capital theories and therefore further research is required to provide evidence on this matter. Based on the above discussion, this paper posits the following hypothesis:

- H<sub>4</sub> INEDs' firm-specific knowledge (proxied by INEDs' tenure) will weaken the negative relationship between RPTs and firm performance
- H<sub>4a</sub> INEDs' firm-specific knowledge (proxied by INEDs' tenure) will strengthen the positive relationship between RPTs with related entities and firm performance
- H<sub>4b</sub> INEDs' firm-specific knowledge (proxied by INEDs' tenure) will weaken the negative relationship between RPTs with related person and firm performance

## RESEARCH METHODOLOGY

### SAMPLE AND DATA SELECTION

The population of this study consists of all firms listed on the Main Market of Bursa Malaysia for the year ended 2013. All finance firms including banking, insurance, trust, closed-end funds and securities are excluded from this study due to their unique characteristics, and are operated in different compliance and regulatory environment (Yatim, Kent & Clarkson 2006) and their performance data are not easy to calculate and to compare with firms in other industries (Claessens et al. 2002). This study uses Krejcie and Morgan's (1970) table as the guideline for estimating the required sample size. The final sample consists of 300 companies. Sample firms are selected based on the proportionate stratified random sampling. This technique is more likely to produce a representative sample and therefore is the most efficient among all probability sampling such as simple random sampling, systematic random sampling and cluster random sampling (Sekaran 2000).

Data for the selected firms are collected from two main sources: Annual reports and DataStream. The English version of annual reports for the period of 2013 are obtained either from the Bursa Malaysia website at [www.bursamalaysia.com.my](http://www.bursamalaysia.com.my) or from the website of the particular company. The data concerning RPTs and INEDs are hand-collected from the 2013 annual reports of the

selected firms. RPTs are typically disclosed in the Related Party Disclosures note, the Directors' Remuneration note or in the Directors' Report. The data relating to INEDs (i.e. number of INEDs, their financial expertise and tenure) are obtained under the board of directors' profile. Other financial data for 2013 are obtained from DataStream.

The year 2013 is chosen because (a) It is the most recent data available at the start of this research. Findings from this study are expected to provide more recent evidence on the topic of interest; (b) RPTs data for the year 2013 can capture the effect of the revised standard of MFRS 124 Related Party Disclosures which is applicable for annual periods beginning on or after 1 January 2012. The revised MFRS 124 simplifies the definition of related party, clarifies its intended meaning and eliminates inconsistencies from the definition and gives partial exemption from disclosures for government-related entities; (c) It can take into account the effect of Corporate Governance Blueprint 2011 released by Securities Commission Malaysia in 2011 and the updated MCGG 2012 on RPTs and INEDs. The Corporate Governance Blueprint 2011 and the revised MCGG 2012 require all listed companies to beef up the roles and responsibility of INEDs. The revised MCGG 2012 focuses, among other, on the independence of INEDs and director's tenure limit; (d) This period is relatively stable in Malaysia both politically and economically and therefore variables tested in this study are expected to not be influenced by a large number of external factors. A one year study period is considered sufficient due to the complexity and time required for hand collection of RPTs and INEDs data.

### MEASURES

*Dependent Variable: Firm Performance* Performance measurement relates to the process of measuring the efficiency and effectiveness of actions (Neely, Gregory & Platts 1995). Following prior studies (e.g. Abdul Wahab 2011; Munir et al. 2013), this study uses return on assets (ROA) as the main proxy for firm performance. ROA is the ratio of net profit to the book value of assets. The ratio has been used extensively by scholars studying corporate governance effectiveness (Haniffa & Hudaib 2006).

*Independent Variables: Related Party Transactions* In Malaysia, the scope and disclosures on related parties and transactions are set out in MFRS 124, Related Party Disclosures, Part E of Chapter 10 of the BMLR and the Companies Act 2016. RPTs as prescribed in MFRS 124 refer to the transfer of resources, services or obligations between related parties, regardless of whether a price is charged or not. RPTs are measured as the sum of the monetary values of RPTs disclosed in the 2013 annual report for each listed firm in the sample, divided by the total assets of the firm as at the fiscal year of 2013.

This study extends prior research by examining whether different types of parties affect firm performance differently. Related parties are classified into two main

groups. The first group is related entities which includes transactions with subsidiaries, associates and joint ventures (RPTRE). The second group is related persons which includes transactions with directors, major shareholder, persons connected with directors or major shareholders or director related entities (RPRP). The procedure to measure these variables are similar with total RPTs where the aggregate monetary values of RPTRE and RPRP are divided by the total assets.

*Moderators: Independent Directors* INEDs are formally defined in paragraph 1.01 of the BMLR as a director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company. INEDs, being independent from the influence of controlling insiders and having a mix of skills, expertise, and knowledge, are expected to limit the insiders' self-serving behavior.

This study focuses on INEDs' presence (INEDPRES) and INEDs' human capital. INEDPRES is regarded as a proxy of board independence and measured as a ratio of INEDs to the total number of directors. INEDs' human capital is regarded as a proxy of INEDs' ability. This study focuses on two dimensions of INEDs' human capital – INEDs' functional knowledge in accounting and finance (INEDFUNK) and INEDs' firm-specific knowledge (INEDSPEK). INEDs' financial expertise is used as a proxy for INEDFUNK and is calculated by the proportion of INEDs with financial expertise to the total number of INEDs. INEDs' tenure serves as a proxy for INEDSPEK and measured as the average tenure of INEDs in the firm. The selection of these proxies is in line with other studies such as De Villiers, Naiker and Van Staden (2011); Guldiken and Darendeli (2016), Johnson et al. (2013), Kor and Sundaramurthy (2009) and Tian et al. (2011).

*Control Variables* This paper employed eight control variables: audit quality (BIG4), board size (BSIZE), firm size (FSIZE), leverage (LEV), controlling shareholders ownership (CSOWN), type of controlling shareholders (CSTYPE), management ownership (MOWN) and industry classifications (INDUSTRY). These control variables have been used in prior studies and have been proven to affect firm performance (Abdul Wahab et al. 2011; Haniffah & Hudaib 2006; Tam & Tan 2007; Sulong & Fauzias 2008). BIG4 is an indicator variable equal to "1" if the firm is audited by Big 4, and "0" otherwise. BSIZE is the total number of directors in the board. FSIZE is the natural log of total assets of the firm. LEV is the ratio of total debt to total assets. CSOWN is a percentage of ownership belongs to the controlling shareholder. CSTYPE is a dummy variable equal to "1" if the controlling shareholder is individual or group of family and "0" otherwise. MOWN is the percentage of ownership belonging to the management.

## RESEARCH MODEL

To examine the relationship between RPTs and firm performance, and whether the presence of INEDs and their human capital could mitigate the RPTs-firm performance relationship, this study employs the following regression models:

$$ROA = \beta_0 + \beta_1 RPTTYPE + \beta_2 INEDVAR + \beta_3 RPTTYPE * INEDVAR + \beta_4 BIG4 + \beta_5 BSIZE + \beta_6 FSIZE + \beta_7 LEV + \beta_8 CSOWN + \beta_9 CSTYPE + \beta_{10} MOWN + \beta_{11} Industry + \varepsilon$$

where;

ROA : Firm performance, measured by ROA = net profit divided by book value of assets

RPTTYPE : Related party transactions, and measured by:

(a) RPTs = total monetary values of RPTs divided by total assets

(b) RPTRE = total monetary values of RPTs with related entities divided by total assets

(c) RPRP = total monetary values of RPTs with related persons divided by total assets

INEDVAR : INEDs' variables, and measured by:

(a) INEDs' presence (INEDPRES) = total number of INEDs divided by total number of directors

(b) INEDs' human capital, and consists of:  
i. INEDs' functional knowledge (INEDFUNK) = total number of INEDs with financial expertise divided by total number of INEDs  
ii. INEDs' firm-specific knowledge (INEDSPEK) = total number of years of service of all INEDs on the board divided by the total number of INEDs

BIG4 : Audit firm = dummy variable coded "1" if the firm is audited by the Big-4 and "0" otherwise

BSIZE : Board size = total members of the board of directors

FSIZE : Firm size = natural log of total assets at the end of financial year

LEV : Leverage = total debt divided by total assets

CSOWN : Controlling shareholder ownerships = total number of shares owned by controlling shareholders divided by total number of firm's shares.

CSTYPE : Types of controlling shareholder = a dummy variable equal to "1" if the controlling shareholder is individual or group of family and "0" otherwise.



- MOWN : Managerial ownership = total number of shares owned by managers divided by total number of firm's shares
- Industry : Industry types = a dummy variable for industry types.

As suggested by Aiken and West (1991), the direct terms used to construct interaction terms in this study are mean centered to avoid the problem of high multicollinearity between the predictor variables and the interaction terms.

## RESULTS

### DESCRIPTIVE ANALYSIS

Table 1 presents descriptive statistics of the variables used in this study. All continuous variables are winsorised at the 1st and 99th percentiles. Even though the winsorising procedure does not fully eliminate the outliers, it can at least limit the effect of extreme values. The dependent variable of this study, ROA represents the firm performance. The mean (median) of ROA is 0.038 (0.038) with a range of -0.511 to 0.358. The results indicate that listed firm in this study make about 3.8% of total assets as net income.

For the RPTs variables, Table 1 shows that total RPTs (RPTs) has a mean (median) value of 0.126 (0.059) with a standard deviation of 0.176. These statistics indicate that, on average, the size of RPTs in the sample of this study is 12.6% of the total assets ranging from a minimum value of 0.0% to a maximum of 94.6%. For types of related parties, transactions with related entities (RPTRE) and transactions with related persons (RPTRP) have a mean (median) value of 0.063 (0.023) and 0.063 (0.017), and with standard deviation of 0.110 and 0.132 respectively. The results suggest that on average, transactions with related entities and with related persons equally contribute to RPTs in Malaysia.

The proportion of INEDs on the board (INEDPRES) is 47%, which is beyond one-third of the minimum requirement set by Bursa Malaysia and Code on Corporate Governance. For INEDs' human capital, approximately 44% of INEDs have membership from accounting/professional bodies or have financial background (INEDFUNK) and their average tenure (INEDSPEK) reaches 7 years.

Table 1 also presents descriptive statistics of control variables used in this study. About 50.3% of the firms in this study are audited by Big 4 firms. The average of board size (BSIZE) is 7 members and ranges from a minimum of 4 members to a maximum of 13 members. The size of the firm (FSIZE) as measured by the log of total assets varies from 16.77 to 25.74 with a mean of 19.85. Leverage (LEV), represented by total debts to total assets, varies from a low of 0.3% to a high of 96.1% with 37.1% mean. This value indicates that some firms in this study are highly leveraged.

With respect to the ownership, the results are not surprising and show that ownership structure of listed firms in Malaysia is highly concentrated. On average, the percentage of ownership belongs to the controlling shareholders (CSOWN) ranges between 0 to 85.5% with a mean of 38.7%. More than 50% of the controlling shareholders (CSTYPE) are individuals or family groups. The level of managerial ownership (MOWN) is low with the

TABLE 1. Descriptive statistics of the variables

n = 300	Mean	Median	Minimum	Maximum	Std. Dev.
ROA	0.038	0.038	-0.511	0.358	0.097
RPTs	0.126	0.059	0.000	0.946	0.176
RPTRE	0.063	0.023	0.000	0.532	0.110
RPTRP	0.063	0.017	0.000	0.850	0.132
INEDPRES	0.465	0.429	0.286	0.800	0.120
INEDFUNK	0.439	0.333	0.000	1.000	0.245
INEDSPEK	6.857	6.583	1.000	20.000	3.818
BIG4	0.503	1.000	0.000	1.000	0.501
BSIZE	7.277	7.000	4.000	13.000	1.777
FSIZE	19.853	19.710	16.770	25.740	1.465
LEV	0.371	0.355	0.003	0.961	0.215
CSOWN	0.387	0.340	0.000	0.855	0.189
CSTYPE	0.507	1.000	0.000	1.000	0.501
MOWN	0.109	0.045	0.000	0.744	0.152

Notes: Please refer to Appendix 1 for variables' definition and measurement. All continuous variables are winsorised at the 1<sup>st</sup> and 99<sup>th</sup> percentile.

mean (median) of 10.9% (4.5%), minimum and maximum amount of 0 and 74.4% respectively.

Table 2 presents a Pearson's correlation matrix among all independent variables included in the ROA model. The findings show a very strong positive correlation between RPTs and RPTRP (0.785) and between RPTs and RPTRE (0.667). However, it should be noted that all regression analysis are performed separately for RPTs variables, hence *there is no issue of multicollinearity*. The correlation with other variables is below 0.50. The results indicate that since the correlation coefficient are less than 0.80, therefore there is no multicollinearity problem among independent variables (Farrar & Glauber 1967).

Further, it is argued that the correlation matrix is not enough to detect multicollinearity problem in an ordinary least squares regression analysis. As suggested by Gujarati (2003), this study performs the Variance Inflation Factor (VIF) as another collinearity diagnostic test. VIF is a measure of the effect of other predictor variables on the standard error of a regression coefficient. The rule of thumb states that if the VIF value exceeds 10 in a given variable, then the variable is considered highly collinear (Gujarati 2003). The VIF results (not tabulated) reveal that none of the VIF value is higher than 10, which indicate that all Models in this study are free from multicollinearity problems.

TABLE 2. Pearson correlation coefficients between independent variables (n = 300)

	1	2	3	4	5	6	7	8	9	10	11	12
1. RPTS	1											
2. RPTRE	0.667***	1										
3. RPTRP	0.785***	0.062	1									
4. INEDPRES	-0.053	-0.036	-0.041	1								
5. INEDFUNK	0.009	-0.002	0.014	-0.197***	1							
6. INEDSPEK	-0.012	-0.015	-0.003	0.002	-0.094	1						
7. BIG4	0.031	0.050	-0.001	-0.012	-0.061	0.118**	1					
8. BSIZE	0.044	0.045	0.022	-0.372***	-0.139**	-0.005	0.177***	1				
9. FSIZE	0.026	0.077	-0.029	-0.066	-0.153***	0.036	0.392***	0.383***	1			
10. LEV	-0.017	-0.022	-0.004	-0.008	-0.070	-0.078	0.051	0.077	0.251***	1		
11. CSOWN	0.156***	0.055	0.163***	-0.152***	0.051	0.041	0.079	0.019	0.094	-0.033	1	
12. CSTYPE	-0.179***	-0.161***	-0.106*	-0.018	0.032	-0.022	-0.207***	-0.181***	-0.294***	-0.030	0.0945	1
13. MOWN	-0.040	-0.033	-0.026	-0.145**	0.079	0.022	-0.116**	-0.061	-0.219***	-0.111***	0.0335	0.448***

Notes: Please refer to Appendix 1 for variables' definition and measurement.

Significant at \*\*\*  $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.10$ .

#### MULTIPLE REGRESSION RESULTS

Table 3 and Table 4 provide the results of regression analysis, examining the relationship between RPTs (or RPTs with related parties) and firm performance and the moderating effects of INEDs' presence and their human capital on this relationship. F-statistics for all models in this study are significant at the level of  $p < 0.01$ . Model 1 in Table 3 shows that, overall, RPTs have a positive effect on firm performance. The coefficient is 0.069 ( $t = 2.189$ ) and is significant at the level of  $p < 0.05$ . The results are robust as seen in Model 2 to Model 5 of Table 3. The positive coefficient of RPTs indicates that firms with higher value of RPTs are associated with higher firm performance, thus Hypothesis 1 which predicts a negative relationship is not supported.

Additional regression analysis classifying RPTs into transactions with related entities (RPTRE) and transactions with related persons (RPTRP) is performed to examine whether different types of parties affect firm performance differently. Model 1 in Table 4 shows that the coefficient of the RPTRE is positive (0.118) and significant at level  $p < 0.05$ . The results are robust as seen in Model 2 to Model 5 of Table 4. The positive relationship implies that RPTs with subsidiaries, associates and joint ventures increases firm performance, which suggests accepting  $H_{1a}$ . This finding gives support to the value-enhancing view of RPTs. The result also reveals that the coefficient for RPTRE is larger and thus suggests that RPTRE is a major attribute contributing to the positive relationship between RPTs and firm performance. However, this study does not find a relationship between RPTRP and firm performance. The coefficient of the RPTRP is positive (0.033) but is insignificant related to ROA. The result suggests rejecting the  $H_{1b}$  which proposes a negative relationship between RPTRP and firm performance.

Hypotheses  $H_2$ ,  $H_{2a}$  and  $H_{2b}$  suggest that INEDs' presence has a positive moderating effect on the relationship between RPTs (or RPTs with related parties)

and firm performance. In other words, this study predicts that the positive (negative) RPTs-firm performance relationship becomes stronger (weaker) as the percentage of INEDs on board increases. The results in Model 2 of Table 3 and Table 4 show that none of the interaction terms of RPTs variables with INEDs' presence (i.e. RPTs\_INEDPRES, RPTRE\_INEDPRES and RPTRP\_INEDPRES) are significant, suggesting that INEDs' presence does not moderate the relationship between RPTs and firm performance. This means that INEDs' presence does not have a positive role to effectively monitor RPTs. Thus,  $H_2$ ,  $H_{2b}$  and  $H_{2c}$  are not supported.

Hypotheses  $H_3$ ,  $H_{3a}$  and  $H_{3b}$  suggest that INEDs' functional knowledge in accounting and finance has a positive moderating effect on the relationship between RPTs (or RPTs with related parties) and firm performance. Specifically, this study postulates that higher levels of financial expertise among INEDs will strengthen (weaken) the positive (negative) relationship between RPTs and firm. The results in Model 3 of Table 3 and Table 4 show that none of the interaction terms of RPTs variables with INEDs' functional knowledge (i.e. RPTs\_INEDFUNK, RPTRE\_INEDFUNK and RPTRP\_INEDFUNK) are significant. The findings are not in line with the predictions and thus  $H_3$ ,  $H_{3a}$  and  $H_{3b}$  are rejected. This means that INEDs' functional knowledge does not play a positive role in enhancing the ability of INEDs to perform their monitoring and advising roles relating to RPTs.

Hypotheses  $H_4$ ,  $H_{4a}$  and  $H_{4b}$  suggest that INEDs' firm-specific knowledge has a positive moderating effect on the relationship between RPTs (and RPTs with related parties) and firm performance. Specifically, this study postulates that INEDs with high levels of firm-specific knowledge will strengthen (weaken) the positive (negative) relationship between RPTs and firm. The results in Model 4 of Table 3 and Table 4 show that none of the interaction terms between RPTs variables and INEDs' firm-specific knowledge (i.e. RPTs\_INEDSPEK, RPTRE\_INEDSPEK and RPTRP\_INEDSPEK) are statistically significant, suggesting that INEDs' firm-specific knowledge does not influence the monitoring and

resource provision effectiveness of INEDs with respect to RPTs, thereby does not help to increase firm performance. Therefore,  $H_{4a}$ ,  $H_{4b}$  and  $H_{4c}$  are not empirically supported.

The results in Model 5 of Table 3 and Table 4 show that the findings are qualitatively identical if all the interaction terms added simultaneously.

TABLE 3. Results of regression analysis – Total RPTs

Variables	Control Variables and RPTs		INEDs' Presence		INEDs' Human Capital				All Variables	
	Model 1		Model 2		Model 3		Model 4		Model 5	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.190	-2.139**	-0.203	-2.176**	-0.184	-2.033**	-0.191	-2.140**	-0.194	-1.985**
RPTs	0.069	2.189**	0.070	2.202**	0.071	2.262**	0.071	2.254**	0.073	2.281**
INEDPRES			0.023	0.465					0.017	0.320
INEDFUNK					-0.005	-0.242			-0.004	-0.160
INEDSPEK							-0.001	-0.459	-0.001	-0.510
RPTs_INEDPRES			0.060	0.230					-0.003	-0.011
RPTs_INEDFUNK					-0.180	-1.323			-0.159	-1.101
RPTs_INEDSPEK							0.007	0.956	0.005	0.622
BIG4	-0.010	-0.880	-0.011	-0.897	-0.010	-0.881	-0.011	-0.929	-0.011	-0.882
BSIZE	0.001	0.164	0.001	0.311	0.000	0.026	0.000	0.115	0.000	0.131
FSIZE	0.013	2.805***	0.013	2.761***	0.013	2.806***	0.014	2.870***	0.014	2.807***
LEV	-0.121	-4.526***	-0.121	-4.492***	-0.121	-4.538***	-0.123	-4.578***	-0.123	-4.506***
CSOWN	0.072	2.456**	0.073	2.453**	0.073	2.481**	0.072	2.454**	0.074	2.475**
CSTYPE	-0.008	-0.580	-0.008	-0.579	-0.006	-0.459	-0.007	-0.545	-0.006	-0.449
MOWN	0.014	0.355	0.017	0.421	0.007	0.182	0.016	0.392	0.011	0.275
Industry	Included		Included		Included		Included		Included	
Adjusted R-squared	0.104		0.099		0.104		0.101		0.0932	
F-statistic	3.489***		3.052***		3.160***		3.110***		2.537***	
Observations	300		300		300		300		300	

Please refer to Appendix 1 for variables' definition and measurement. Industry effects are included but not reported for brevity.

Significant at \*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.10$

## DISCUSSION AND CONCLUSION

The objectives of this paper are to provide evidence concerning the effect of RPTs (or RPTs with related parties) on firm performance and whether this effect is moderated by INEDs' presence and their human capital (i.e. INEDs' functional and firm-specific knowledge). A few conclusions can be drawn from the results of this study. First, this study provides evidence that, on average, RPTs are not harmful to minority shareholders. Specifically, the results indicate that RPTs in general, have a positive effect on firm performance. For the subtypes of related parties, the results reveal that transactions with different types of related parties affect firm performance differently and transactions with subsidiaries and affiliated firms have a greater effect in enhancing firm performance. The positive effect implies that a firm with higher RPTs have a higher firm performance, and thus supports the value-enhancing view (i.e. efficient transactions hypothesis) of RPTs. In the Malaysian context, the findings contradict earlier findings of Abdul Wahab et al. (2011); Hasnan et al. (2016) and Munir et al. (2013). The positive relationship between RPTs and firm performance may be partly explained by the many reforms to the laws, regulations and guidelines since 2000, attempting to reduce the prevalent of abusive

RPTs in Malaysia. Furthermore, as argued by Utama, Utama and Yuniasih (2010), in countries with imperfect markets like Malaysia, RPTs may rationally serve various economic and business needs of the firms. Malaysia's economy is characterized by a relationship-based system and therefore RPTs are a common business deal among Malaysian companies.

Second, there is no support for the hypothesis that INEDs' presence moderates the relationship between RPTs (or RPTs with related parties) and firm performance. The insignificant finding contradicts with the arguments from the agency theory. As argued by Abdullah, Ku Ismail and Nachum (2015), Malaysia, like other emerging countries, INEDs is "a concept deprived of its actual meaning". The mere presence of INEDs does not mean that they can serve an effective governance role. The INEDs may only play a symbolic role that tends to have less influence in monitoring the decision making of insiders to enter into RPTs. There is a possibility that firms appoint INEDs to just meet the legal definition of independence but the INEDs are close to the management and act primarily in the interest of the insiders (Abdullah et al. 2015). In this situation, the related parties may have an opportunity to dominate and control the decision-making process. The insignificant results may also be explained from the perspective of

TABLE 4. Results of regression analysis – RPTs With Related Parties

Variables	Control Variables and Type of Parties		INEDs' Presence		INEDs' Human Capital				All Variables	
	Model 1		Model 2		Model 3		Model 4		Model 5	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.187	-2.107**	-0.200	-2.142**	-0.181	-1.991**	-0.183	-2.045**	-0.187	-1.905*
RPTR	0.118	2.393**	0.127	2.516**	0.119	2.403**	0.119	2.398**	0.129	2.530**
RPTRP	0.033	0.791	0.029	0.687	0.039	0.916	0.036	0.867	0.035	0.818
INEDPRES			0.018	0.350					0.004	0.079
INEDFUNK					-0.005	-0.229			-0.001	-0.028
INEDSPEK							-0.001	-0.709	-0.001	-0.611
RPTRP_INEDPRES			0.336	0.830					0.330	0.775
RPTRP_INEDFUNK			-0.208	-0.500					-0.392	-0.893
RPTRP_INEDSPEK					-0.067	-0.311			-0.003	-0.015
RPTRP_INEDFUNK					-0.252	-1.433			-0.193	-1.001
RPTRP_INEDSPEK							-0.010	-0.631	-0.007	-0.447
RPTRP_INEDSPEK							0.015	1.528	0.013	1.155
BIG4	-0.010	-0.878	-0.011	-0.877	-0.011	-0.889	-0.011	-0.933	-0.011	-0.899
BSIZE	0.001	0.180	0.001	0.241	0.000	0.049	0.000	0.067	0.000	-0.004
FSIZE	0.013	2.728***	0.013	2.721***	0.013	2.712***	0.013	2.787***	0.013	2.769***
LEV	-0.120	-4.503***	-0.119	-4.403***	-0.122	-4.547***	-0.124	-4.616***	-0.122	-4.468***
CSOWN	0.074	2.535**	0.077	2.573**	0.074	2.529**	0.076	2.576**	0.078	2.598**
CSTYPE	-0.007	-0.531	-0.007	-0.504	-0.005	-0.372	-0.007	-0.548	-0.005	-0.387
MOWN	0.013	0.324	0.014	0.345	0.006	0.147	0.015	0.366	0.009	0.213
Industry	Included		Included		Included		Included		Included	
Adjusted R-squared	0.106		0.100		0.104		0.105		0.093	
F-statistic	3.376***		2.852***		2.925***		2.953***		2.280***	
Observations	300		300		300		300		300	

Please refer to Appendix 1 for variables' definition and measurement. Industry effects are included but not reported for brevity.

Significant at \*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.10

the institutional theory that INEDs are appointed due to external institutional pressure such as pressure from government regulations and corporate governance reforms (Kim 2007; Peng 2004). Therefore, the presence of INEDs in the boardroom may not necessarily improve the quality of firms' corporate governance. This is consistent with the argument by DiMaggio and Powell (1983) that "...structural change in organizations seems less and less driven by competition or by the need for efficiency... organization change occurs a result of the process that makes organizations more similar without necessarily making them more efficient" (DiMaggio & Powell 1983: 147).

Third, the insignificant moderating effect of INEDs' human capital on RPTs-firm performance relationship can be explained from the perspective of information processing theory that the individuals' ability to process information depends on his/her cognitive capabilities. Once the individuals' cognitive thresholds are reached, his/her ability to effectively process information declines (O'Reilly 1980). Khanna et al. (2014) argued that the excessive information demands faced by directors mitigate the benefits associated with their human capital. In Malaysia, INEDs are expected to perform their monitoring role by means of sitting in a number of

watch-dog committees, including the audit, remuneration and nominating committees (Anuar & Abdul Rashid 2015). They also sit on multiple corporate boards. The substantive involvement of INEDs in these committees and another board require them to process a large amount of information in order to fulfill their roles. These information processing demands may weaken their ability (i.e. INED's human capital) to effectively monitor and advise managers and controlling shareholders (Khanna et al. 2014). Others argue that since INEDs are not full-time directors and are not involved in the operational and management aspects of the company, they face information asymmetries that may hamper their decision-making process.

The findings from this study imply that in emerging markets like Malaysia where external markets are inefficient, the benefits of RPTs are more likely to outweigh the costs provided there are rules and regulations available to monitor such transactions. Findings from this study also raise concerns whether INEDs add value to the firm, as this study does not find evidence that resource-rich INEDs can serve as an effective governance mechanism. This suggests that the regulatory bodies in Malaysia need to revisit existing governance practices which tend to rely heavily on INEDs to address corporate governance issues.

This study suffers from a number of limitations, which may provide potential avenues for future research. First, data collection. Data relating to RPTs and INEDs are hand-collected based on information disclosed in the annual reports. There is a possibility that firms engaging in RPTs do not disclose the information as they may not be subject to the disclosure requirement by BMLR and MASA or they may be concealed by the management for their own interest. Therefore, the RPTs data used in this study is limited to the information disclosed in the annual reports. Other disclosure channels such as circulars to shareholders and minutes of shareholders' or directors' meetings should be considered in future studies. For INEDs information, the use of secondary data to measure INEDs' human capital provides limited evidence regarding the qualitative nature of INEDs' knowledge. Future research can use primary information obtained from survey or interviews with INEDs in order to gauge their direct psychological information. Second, proxies for INEDs' human capital. This study uses two proxies to capture INEDs' human capital namely INEDs' functional and firm-specific knowledge. INED's human capital is a multidimensional concept (Gayle, Golan & Miller 2015) that represents directors' skills, knowledge and expertise (Hillman & Dalziel 2003; Johnson et al. 2013). Using different proxies to measure INEDs' human capital, therefore, could yield different results. Some caution is required in interpreting findings from this study in light of the multidimensional and complex nature of measuring the INEDs' human capital. Third, cross-sectional study. Due to time constraints on data collection, the study focuses on data for the year 2013 only. Therefore, the results cannot be generalized beyond this period of study and should be interpreted with caution. This study could be extended by using panel data technique to better explain the effect of RPTs and the moderating role of INEDs' presence and their human and social capital on firm value.

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## APPENDIX

## APPENDIX 1. Definition and measurement of the variables

Variables	Definition	Measurement
ROA	Return on asset	net profit to the book value of assets
RPTs	Total RPTs	total monetary values of RPTs divided by total assets
RPTRE	RPTs with related entities	total monetary values of RPTs with related entities divided by total assets
RPTRP	RPTs with related persons	total monetary values of RPTs with related person divided by total assets
INEDPRES	INEDs' presence	total number of INEDs divided by total number of directors
INEDFUNK	INEDs' functional knowledge in accounting and finance	total number of INEDs with financial expertise to total number of INEDs
INEDSPEK	INEDs' firm-specific knowledge	total number of years of service of all INEDs divided by total number of INEDs
BIG4	Audit firm	a dummy variable equal to "1" if the firm is audited by Big 4, and "0" otherwise
Bsize	Board size	total members of the board of directors
Fsize	Firm size	natural log of total assets of the firm
LEV	Leverage	total debt divided by total assets
CSOWN	Controlling shareholders ownership	a percentage of ownership belongs to the controlling shareholder
CSTYPE	Types of controlling shareholders	a dummy variable equal to "1" if the controlling shareholder is individual or group of family and "0" otherwise
MOWN	Managerial ownership	a percentage of ownership belongs to management.