THE CHARACTERISTICS OF BOARD OF DIRECTORS AND RELATED PARTY TRANSACTIONS

Kyeongmin Jeon, Sungkyunkwan University

ABSTRACT

Recently, accounting scandals have raised considerable concern among regulators, and accounting professionals about related party transaction in Korea. According to prior research, related party transactions could be used as a source of earning management. This study examines whether there is an association between related party transaction that allegedly are used to manipulate earnings and corporate governance, particularly focusing on the characteristics of board of directors. The purpose of this paper is also to investigate whether good governance structures (characteristics of board of directors) help constrain management opportunistic behavior in Korean listed firms. The characteristics of board of directors are measured by size, independence, expertise and activity. This paper provides evidence that independence and expertise of the board of directors are associated with lower related party transactions. These results suggest that board of directors play a significant role in monitoring transactions between related parties, in turn, reducing effectively these dealings.

Keywords: Corporate Governance, Board of Directors, Related Party Transaction.

INTRODUCTION

Recently, the entrenched business malpractice of chaebol (Top 30 companies in Korea) owners and their family members receiving huge dividends through unlisted companies remains intact despite many criticisms. Some of the unlisted companies made hefty dividend payouts, which often serves as an illicit means for tycoons to transfer wealth to their children at the expense of the shareholders of a chaebol listed subsidiaries (Korea Times, 2014). To do so, it could be possible to transfer the profit through the related party transaction. Many prior literatures argue that related party transaction among group firms can reduce transaction costs and enhance the enforcement of property rights and contracts (Fisman & Khanna 1998; Shin & Park, 1999; Fan & Goyal, 2002). However, controlling shareholders can take advantage of these related party transactions for opportunistic purposes. Through related dealings, cash and profits are diverted away from firms in a group either to controlling shareholders' pockets directly or to assist troubled firms within the same group (Jian & Wong, 2004). Johnson et al. (2000) show that firms in developed markets also use related party transaction to transfer assets and profits out of firms for the benefit of those who control them. Related party transaction has emerged as direct evidence of wealth exploitation (Cheung et al., 2006; Berkman et al., 2009).

Khanna & Yafeh (2000) find that group controlling firms can manipulate profits by adjusting either the volume or price of intra-group trade. The association between earnings management and related party transactions is an important issue in accounting and fair trading research.

Nowadays, corporate governance has become an important issue in business environments. When large corporations are controlled by a small number of people, the issue of corporate governance becomes important because corporations can easily be manipulated to their benefit at the expense of public interest. Therefore, the risk that these dealings may damage stakeholders gives rise to a demand to monitor such transactions. Nowadays, corporate governance has become an issue of enormous relevance in business and economics.

Under the new rule, applicable from April 1, 2012, a company belonging to a business group with aggregate assets exceeding 5 trillion won is required to obtain prior approval from the board of directors when it places an order valued at 5 billion won or more with a sister affiliate. The FTC has also strengthened the disclosure rule, obliging a chaebol unit to disclose its deal with a sister firm when the latter is 20 percent or more owned by members of its owner family. But companies can easily avoid this requirement by splitting a deal into smaller units. Furthermore, most companies have filled their board seats with directors who rarely object to proposals from management.

This study investigates whether there is an association between related party transaction and corporate governance; particularly the characteristics of board of directors. The rest of this paper is organized as follows: author describes related researches regarding related party transactions; corporate governance and develops the hypotheses; research design and sample selection.

LITERATURE REVIEW

Related Party Transactions

Related party transactions are defined as transactions between a company and its subsidiaries, affiliates, principal owners, officers or their families, directors or their families or entities owned or controlled by its officers or their families (Statement of Financial Accounting Standards No 57, FASB 1982).

There are two contrasting views on the effect of related party transactions on firm performance. The first view is the conflict of interest view, the other is efficient transaction view. Gordon et al. (2004) argue that related party transaction are detrimental and value decreasing for shareholders and find that industry-adjusted returns are negatively associated with related party transactions. Jian and Wong (2004) suggest that cash and profits are diverted away from firms in a group either to controlling shareholders' pockets directly or to assist troubled firms within the same group through related dealings. Kohlbeck & Mayhew (2010) find that firms with related party transactions have significantly lower valuation and marginally lower subsequent return than firms with no such transactions.

While many prior studies argue that related party transactions among group members can help reduce transaction costs and enhance the enforcement or property rights and contracts (Fisman & khanna, 1998; Fan & Goyal, 2002). However, controlling shareholders can take advantage of these related party transactions for opportunistic purpose. Few prior researches provide evidences that related party transactions are associated with earnings management. Khanna & Yafeh (2000) find that group controlling firms can manipulate profits by adjusting either the volume or price of intra-group trade. When related party transactions especially related party sales are involved, operating earnings can be managed. Kim and Woo (2008) provide evidences that the related party transactions are used as a way of earnings management and investors estimates the transactions negatively. Aharony et al. (2000) show that related party sales and services could be used opportunistically to manage earnings upwards in the pre-IPO period. In some of these cases, related party transactions are allegedly used to manipulate earnings. Many prior researches suggest that related party transactions could be used as a source of earning management.

Corporate Governance

Corporate governance mechanisms help to control agency costs either by improving the alignment of manager's interest with those of outside shareholders or by monitoring the managers to deter them from engaging in opportunistic actions (Charreaux, 1997). Klein (2002) finds that there is a negative relation between board independence and abnormal accruals and reductions in board independence is accompanied by large increases in abnormal accruals.

Few literatures document a negative relation between outside directors and the incidence of financial fraud (Dechow et al., 1996; Beasley, 1996). Prior researches suggest that good corporate governance serves as an effective mechanism to alleviate the opportunistic behaviors of management, to improve the accounting information quality, and to enhance the firm value (Chen et al., 2009; Bhagat & Bolton, 2008; Denis & McConnell, 2003). Good governance mechanism in terms of the board of directors should enhance the fairness among the different stakeholders on the business (Collier & Esteban, 1999; Jensen, 2005; Matten & Crane, 2005). Furthermore, independent directors should ensure that financial decisions are made in the best interests of all shareholders and should not result in earnings or cash flows that are biased toward the managers, controlling shareholders, or the minority shareholders (Donaldson and Preston, 1995).

Board members with corporate or financial backgrounds are associated with firms that have smaller discretionary current accruals and board meeting frequency is also associated with reduced levels of discretionary current accruals (Xie et al., 2003) different sources, critically evaluate it and resent your conclusions in a concise, logical and reader-friendly manner.

HYPOTHESES DEVELOPMENT

American Institute of Certified Public Accountants (AICPA) suggests that one of the important and difficult aspects of financial statement audit is the identification of related parties and transactions with related parties. Related parties such as controlled entities, principal stockholders or management can execute transaction that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud the company by transferring funds to conduit related partied and ultimately the perpetrators (AICPA, 2001).

Recently, accounting scandals have raised considerable concern among regulators, and accounting professionals about related party transactions. RPT dealings among affiliates could impact the reliability of reported of financial information both in terms of representational faithfulness and reliability of reported amounts.

Jian & Wong (2004) suggest that cash and profits are diverted away from firms in a group either to controlling shareholders' pockets directly or to assist troubled firms within the same group through related dealings. Khanna & Yafeh (2000) find that group controlling firms can manipulate profits by adjusting either the volume or price of intra-group trade. When related party transactions especially related party sales are involved, operating earnings can be managed. Kim & Woo (2008) provide evidences that the related party transactions are used as a way of earnings management and investors estimates the transactions negatively. Aharony et al. (2000) show that related party sales and services could be used opportunistically to manage earnings upwards in the pre-IPO period. In some of these cases, related party transactions are allegedly used to manipulate earnings.

When large corporations are controlled by a small number of people, the issue of corporate governance becomes important because corporations can easily be manipulated to their benefit at the expense of public interest. Weaker corporate governance mechanisms are associated with more and higher dollar amounts of related party transactions (Jensen & Meckling, 1976; Gordon et al., 2004). Related party transactions can also affect the reliability of financial statements.

Therefore, the risk that these dealings may damage stakeholders gives rise to a demand to monitor such transactions. Monitoring can discourage or prevent related party transactions from extracting wealth from the firms or misreporting. On the other hand, companies that engage in related party transaction can attempt to signal to investors the transactions' benefits by adopting monitoring mechanisms designed to prevent wealth extraction or financial misreporting by assigning independent directors to review RTP (Kohlbeck & Mayhew, 2010). The proportion of outsiders on the board is negatively related to the likelihood to avoid reporting both losses and earnings reductions (Kim, 2006).

This study investigates whether there is an association between related party transaction and corporate governance and particularly focuses on the characteristics of board of directors: independence, expertise, activity.

Hypothesis 1: There is no association between related party transaction and size of board of directors.

Hypothesis 2: There is no association between related party transaction and independence of board of directors.

Hypothesis 3: There is no association between related party transaction and expertise of board of directors.

METHODOLOGY

Sample Selection

This study uses the sample of Korea publicly listed companies for the periods ending 2011 and 2015. The sample consists of all firms with available financial data from KIS-Value and detail of corporate governance from the website of Korea’s Financial Supervisory Service (http:dart.fss.or.kr). Firms in the financial industry are excluded because they operate in highly regulated industries with accounting rules that differ from other industries. We also exclude firms whose year-end is not on Dec 31 to ensure homogeneity. After this selection process, the final sample included 2,712 firm-years (Table 1).

Research Model

Board of directors is charged with monitoring management to protect shareholders’ interests and independent outside directors monitors management more effectively than inside directors. Prior researches suggest that related party transactions could be used as a source of earning management. This study examines whether there is an association between related party transactions that allegedly used to manipulate earnings and corporate governance, particularly focuses on the characteristics of board of directors: independence, expertise, activity. To test the hypothesis, this study performs the following OLS multivariate regression model.

Table 1 SAMPLE SELECTION	
Criteria	**Number of Firm-Year**
Total sample 2011~2015	4,355
Less: Financial institutions	910
Less: Non December 31 fiscal year end firms	120
Less: firms without necessary financial data	613
Total	2,712

$$\mathrm{RPT} = \beta_0 + \beta_1 Gov + \beta_2 Foreign + \beta_3 EBITA + \beta_4 Size + \beta_5 Lev + \beta_6 BIG4 + \beta_7 Owne + \beta_8 Large + \beta_9 OCF + \varepsilon \quad (1)$$

Where,
RPT; natural log (total amount in related party transactions), Gov; characteristics of board of directors, 1) board size: number of members in the board of directors, 2) independence: percentage of outside directors on the board, 3) expert: a dummy variable that equal 1 if the firm have an expertise in the board of directors, 4) activity: ratio of attendance of outside directors at board meeting, Foreign: total percentage of shares owned by foreign investors, Own: total percentage of shares owned by large shareholder, Big4: Anjin-Deloitte, Hanyoung-Ernst & Young (EY), Samjung-KPMG and Samil-PricewaterhouseCoopers (PwC) are the four biggest accounting services networks in Korea, a dummy variable that equal 1 if the audit firm is big4 and 0 otherwise, Large: a dummy variable that equal 1 if the company is large firm and 0 otherwise

EBITA: earnings before interest, taxes, depreciation and amortization by lagged total assets Size: natural logarithm of total assets, Lev: ratio of total debt and total assets, OCF: operating cash flow

To examine the relationship between corporate governance mechanism and related party transactions after controlling the effect of other governance variables, this study also includes CGS variable that is the governance scores annually compiling and reported by the Korea corporate governance service.

$$RPT = \beta_0 + \beta_1 Gov + \beta_2 Foreign + \beta_3 EBITA + \beta_4 Size + \beta_5 Lev + \beta_6 BIG4 + \beta_7 Owner + \beta_8 Large + \beta_9 OCF + \beta_{10} CGS + \varepsilon \quad (2)$$

Control Variables

Dependent variable: Related party transaction variables

To investigate the impact of corporate governance on related party transactions, this study employs the natural logarithm of firm's total related party transactions. Author uses the total amount to gauge the importance to the related party transactions, expecting that higher value intensify any conflicts of interest (Gordon et al., 2004).

Corporate governance variable

This research considers the relationship between related party transactions and corporate governance particularly focuses on the characteristics of board of directors such as board independence, expertise, activity, and size. This study uses the following variables for corporate governance, INDEPENDENCE which is measured by the proportion of outside directors, EXPERTISE which takes the value of 1 if there is an expert among outside directors, ACTICITY which is measured by ratio of attendance of outside directors at board meeting, and board size.

Control variables

Based on prior studies (Lo et al., 2010; Shin and Na, 2015; Balsam et al., 2017), some other factors influencing related party transactions of a firm are included in the regression model as a control variable. This research control for firm size by including the natural log of total assets (SIZE), and control for leverage (LEV) which is the ratio of total debt to total assets. The study include FOREIGN (i.e., total percentage of shares owned by foreign investors), OWN (i.e., total percentage of shares owned by large shareholder), BIG4 (i.e., a dummy variable which is equal to 1 if the t firm is audited by big 4 auditors), LARGE (i.e., a dummy variable which is equal to 1 if the company is large firm), EBITA (i.e., earnings before interest, taxes, depreciation and amortization by lagged total assets), OCF(i.e., operating cash flow) in regression model to control for possible effects on related party transactions.

DATA ANALYSIS AND RESULTS

Descriptive statistics and univariate analysis

Table 2 provides descriptive statistics of the variables used in this study. It shows that the mean of related party transaction is 11.757. It also shows that among the sample, firms have 29.6% of the directors are independent directors. 27% of the sample firms have an expert among members of outside directors and average 7.61 members in board of directors. 70.9% of outside directors attend the board meeting.

Table 2
DESCRIPTIVE STATISTICS

	Mean	Median	Min	Max	S.D
RPT	11.75	0.00	0.00	30.84	11.88
BOD-Size	7.61	7.00	1.00	31.00	2.60
Independence	0.29	0.25	0.00	1.00	0.18
Expertise	0.27	0.00	0.00	1.00	0.45
Activity	0.70	0.85	0.00	1.00	0.32
Foreign	0.09	0.03	0.00	0.78	0.14
EBITA	0.04	0.04	-2.75	0.49	0.09
Size	26.43	26.13	22.71	32.30	1.45
Lev	1.18	0.78	0.00	69.13	2.57
Big4	0.69	1.00	0.00	1.00	0.46
Owner	0.29	0.30	0.00	1.00	0.23
Large	0.84	1.00	0.00	1.00	0.36
OCF	2.75	0.00	0.00	30.18	7.56

Table 3 provides the Pearson correlation matrix for the variables used in regression analysis. As shown, related party transaction is significantly negatively correlated with size, independence, expertise, activity of board of directors. Related party transaction is also significantly negatively correlated with Foreign, Big4 and size. Moreover, related party transaction is significantly positively correlated with Owner and operating cash flow. All the variance inflation factors are less than two, thus giving little cause for concern about the multicollinearity problem.

Table 3
CORRELATIONS MATRIX

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1)RPT	1.000	-0.04	-0.085	-0.076	0.011	-0.050	-0.118	-0.003	-0.099	-0.039
(2)BOD-Size		1.000	0.104	0.166	-0.056	0.295	0.174	0.062	0.394	0.044
(3)In depend			1.000	0.220	0.081	0.182	0.133	0.030	0.425	0.045
(4)Expertise				1.000	0.094	0.192	0.109	0.050	0.244	-0.003
(5)Activity					1.000	0.088	0.079	0.081	0.099	-0.072
(6)Foreign						1.000	0.250	0.198	0.439	-0.077
(7)Big4							1.000	0.092	0.375	0.025
(8)EBITA								1.000	0.172	-0.113
(9)Size									1.000	0.087
(10)Lev										1.000

Two-tailed t-test, coefficients in bolds are significant at less than 5% levels.

Table 4 Column C reports the OLS regression results of Model (3) where the dependent variable is total amount of related party transactions; the value of natural log of total amount. The negative coefficient on independence and expert implies that firms with a higher percentage of independent or expertise directors are associated with lower amount of related party transaction.

There are two contrasting views on the effect of related party transactions. The first view is related party transactions could create a potential conflict of interest between manager and shareholders (Balsam et al. 2017). These transactions are detrimental and value decreasing for shareholders (Gordon et al., 2004). Jian & Wong (1010) report that a manager may engage in earnings management through these dealings. However, the stronger corporate governance, the lower earnings management. While some of prior studies argue that related party transactions among group members can help reduce transaction costs and enhance the enforcement or property rights and contracts (Fisman & khanna, 1998; Fan & Goyal, 2002).

This study provides evidence that the independent and expertise directors can plays a effective monitoring role in mitigating related party transactions which could be used as a source of earning management. The research also found firms which audited by Big 4 auditor have a negative relationship with related party transaction. It means that Big 4 auditor also effect on related party transactions.

Collectively, these findings have a contribution to the debate about the competing theoretical perspective and mixed results of prior studies. In other words, the effectively monitoring of independent and expert directors could transfer related party transactions from conflicts of interest to efficient transactions.

Table 4
RESULT OF REGRESSION- MODEL (1)

Independent Variable	**Gov(1) (t-stat)**	**Gov(2) (t-stat)**	**Gov(3) (t-stat)**	**Gov(4) (t-stat)**
Intercept	23.289*** (4.023)	20.591*** (3.421)	22.156*** (3.825)	23.763*** (4.166)
BOD_Size	-0.066 (-0.616)			

Table 4
RESULT OF REGRESSION- MODEL (1)

Independence		-2.490* (-1.711)		
Expert			-1.580*** (-2.739)	
Activity				0.504 (0.879)
Foreign	-0.746 (-0.364)	-0.942 (-0.465)	-0.439 (-0.216)	-0.960 (-0.473)
EBITA	2.662 (0.970)	2.535 (0.924)	2.755 (1.005)	2.604 (0.948)
Size	-0.393* (-1.650)	-0.275 (-1.114)	-0.313 (-1.349)	-0.443* (-1.937)
Lev	-0.141 (-1.470)	-0.143 (-1.491)	-0.146 (-1.523)	-0.138 (-1.443)
Big4	-2.164*** (-3.671)	-2.180*** (-3.699)	-2.157*** (3.664)	-2.186*** (-3.705)
Owner	1.152 (0.886)	0.988 (0.759)	1.229 (0.949)	1.235 (0.341)
Large	0.735 (0.941)	0.622 (0.794)	0.674 (0.886)	0.752 (0.964)
OCF	-0.004 (-0.084)	0.001 (0.013)	-0.009 (-0.176)	0.504 (0.879)
Year fixed effect	Yes	Yes	Yes	Yes
Industry fixed effect	Yes	Yes	Yes	Yes
Obs. Adjusted R^2	2,712 0.05	2,712 0.05	2,712 0.05	2,712 0.05

*Two-tailed t-tests, *,**,*** significant at 10%, 5%, and 1% levels, respectively.

RPT; natural log (total amount in related party transactions), Gov; characteristics of board of directors, 1) board size: number of members in the board of directors, 2) independence: percentage of outside directors on the board, 3) expert: a dummy variable that equal 1 if the firm have an expertise in the board of directors, 4) activity: ratio of attendance of outside directors at board meeting, Foreign: total percentage of shares owned by foreign investors, Own: total percentage of shares owned by large shareholder, Big4; a dummy variable that equal 1 if the audit firm is big4 and 0 otherwise, Large; a dummy variable that equal 1 if the company is large firm and 0 otherwise, EBITA: earnings before interest, taxes, depreciation and amortization by lagged total assets, Size: natural logarithm of total assets, Lev: ratio of total debt and total assets, OCF: operating cash flow

Table 5 shows the relationship between corporate governance mechanism and related party transaction through the model included the corporate governance score (CGS). There is no significantly association between corporate governance score and related party transaction.

Table 5
RESULT OF REGRESSION- MODEL (2): INCLUDED CGS

Independent variable	Gov(1) (t-stat)	Gov(2) (t-stat)	Gov(3) (t-stat)	Gov(4) (t-stat)
Intercept	19.723*** (3.051)	18.381*** (2.794)	19.936*** (3.096)	19.8333*** (3.080)
BOD_Size	-0.068 (-0.619)			
Independence		-1.924* (-1.251)		
Expert			-1.336**	

Table 5 RESULT OF REGRESSION- MODEL (2): INCLUDED CGS				
			(-2.229)	
Activity				0.536 (0.919)
Foreign	-0.221 (-0.105)	-0.468 (-0.225)	-0.091 (-0.044)	-0.416 (-0.200)
EBITA	2.921 (1.035)	2.793 (0.989)	2.962 (1.051)	2.894 (1.025)
Size	-0.146 (-0.504)	-0.102 (-0.350)	-0.143 (-0.501)	-0.175 (-0.615)
Lev	-0.116 (-0.998)	-0.111 (-0.954)	-0.115 (-0.994)	-0.116 (-1.002)
Big4	-2.199*** (-3.672)	-2.206*** (-3.684)	-2.182*** (3.647)	-2.225*** (-3.712)
Owner	0.667 (0.495)	0.598 (0.444)	0.803 (0.597)	0.737 (0.548)
Large	0.841 (1.058)	0.769 (0.964)	0.816 (1.027)	0.849 (1.069)
OCF	0.009 (0.183)	0.013 (0.253)	0.004 (0.086)	0.011 (0.223)
CGS	-0.077* (-1.815)	-0.067 (-1.545)	-0.062 (-1.442)	-0.083* (-1.961)
Year fixed effect	Yes	Yes	Yes	Yes
Industry fixed effect	Yes	Yes	Yes	Yes
Obs. Adjusted R^2	2,092 0.044	2,092 0.045	2,092 0.047	2,092 0.045

Two-tailed t-tests, *,**,*** significant at 10%, 5%, and 1% levels, respectively.

CONCLUSIONS AND RECOMMENDATIONS

According to prior research, related party transactions could be used as a source of earning management, and dealings among affiliates could negatively impact the reliability of financial report both in terms of representational faithfulness and reliability of reported amounts. Hence, although related party transactions can offer higher return to the firms, most of these transactions actually may be harmful to shareholders. Therefore, RPTs need to be the subject of close scrutiny by corporate governance. This study examines the relationship between related party transactions and the characteristics of board of directors. The researchers has analyzed whether the board of directors plays as a control device on related party transaction.

This research provides evidence that independence and expertise of the board of directors are associated with a lower related party transaction. These results suggest that board of directors' monitoring plays a role in reducing the related party transaction. Researchers found firms which were audited by Big 4 audit firms have a negative relation with related party transaction. It means that Big 4 auditor also affect related party transaction. Collectively, these findings suggest that independence and expertise of the board of directors and Big4 firms are able to monitor the process of related party transactions.

This study provides direct an evidence for the relation between related party transaction and characteristics of governance; particularly the characteristics of board of directors. Author has been found evidence that corporate governance might have a moderate effect for reducing related party transactions as a source of earnings management. This paper does not also address the characteristic of audit committee or other factors that it could be affect related party transactions such as CEO compensation. It could be a future research issues.

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