

Related Party Transactions: Associations with Corporate Governance and Firm Value

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Abstract

Public accountants, regulators, stock market participants and other corporate stakeholders express concern about related party transactions. Recent corporate scandals have highlighted this concern, prompting Sarbanes-Oxley (SOX) to prohibit personal loans to executives and non-executive board members. Yet, little rigorous academic research describes the extent of related party transactions (RPTs) in companies or investigates their underlying nature. In a representative sample of companies for a period that predates SOX, we find RPTs are wide spread and involve equally executives and non-executive board members; additionally, there are fewer related party loans than other non-loan related party transactions such as purchases or direct services. When we examine the relationship between RPTs and the extant literature's corporate governance mechanisms (such as board characteristics, CEO pay-performance sensitivity, and outside monitors), we generally find weaker corporate governance mechanisms associated with more and higher dollar amounts of RPTs. We also find that industry-adjusted returns are negatively associated with RPTs. On further examination of loans versus other types of RPTs not considered in SOX, we find a negative relationship between industry-adjusted returns and the number and dollar amount of loans to executives and non-executive directors, and a similar relationship between the number of other types of RPTs with non-executive directors. In summary, our results provide support for the view of RPTs as conflicts of interest between managers/board members and their shareholders, in contrast with the view of RPTs as efficient transactions.

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1. Introduction

Related party transactions are one of the recurring areas of concern raised by recent corporate scandals. These transactions are often diverse complex business transactions between a company and its managers, directors, or principal owners.¹ In public accounting, they are considered difficult to audit and a potential indicator of audit risk (AICPA 2001, Johnstone and Bedard 2004).² The General Accounting Office (2003) identified related party transactions as one of the nine major reasons leading companies to restate financial statements. Regulators, market participants, and other corporate stakeholders commonly regard these transactions as potential conflicts of interest that can compromise management's agency responsibility to shareholders or a board of director's monitoring function.³ These similar views about related party transactions, which we refer to as the conflict of interest hypothesis, are consistent with agency concerns considered by Berle and Means (1932) and Jensen and Meckling (1976). An alternative view, which we refer to as the efficient transactions hypothesis, is that related party transactions efficiently fulfill underlying economic needs of the company. Although questions, concerns and uncertainties about the underlying nature of related party transactions exist, there is little rigorous academic research to confirm or refute the views of them. In this paper, we explore these two hypotheses by examining the relation of RPTs with corporate governance mechanisms and their association with firm value.

Corporate governance issues, like those with related party transactions, arise because of asymmetric information problems between external capital markets and the firm's managers. If external capital markets could perfectly observe the manager's investment actions and effort, there would be no need for corporate governance mechanisms to help monitor or incentivize the manager, as one could construct perfect penalties to preclude non-value maximizing behavior. The existing literature has found certain board characteristics and CEO pay-performance sensitivity to be useful governance mechanisms in ameliorating managerial agency problems; additionally, higher leverage, and the presence of large shareholder ownership are capital structure features that also play a

governance role to mitigate managerial agency problems. For example, large board size, which is observable and disclosed in proxy statements, has been found to be negatively correlated with firm value and interpreted as indicative of weak corporate governance (Yermack, 1996). Using a similar logic, we examine whether related party transactions are detrimental or helpful to firm value, and whether they are correlated with these other corporate governance mechanisms.

Although related party transactions are commonly viewed as potential conflicts, we develop two contrasting hypotheses that are consistent with rational economic arguments.⁴ Under the conflict of interest hypothesis, related party transactions compromise management's agency responsibility to shareholders or a board of director's monitoring function. In such a case, related party transactions would be more prevalent when a firm's corporate governance mechanisms are weak, and such firms would have lower adjusted stock returns. The alternative efficient transactions hypothesis is that related party transactions efficiently fulfill underlying economic needs of the company. If related party transactions are efficient transactions, there would be no need to increase monitoring; as a result, there would be no association between related party transactions and strength of corporate governance mechanisms, and no adverse impact on shareholders. However, even if related party transactions are efficient transactions, a company can choose to increase monitoring to avoid the appearance of conflicts of interest. In this case, we would expect a positive association between stronger governance structures and related party transactions.

We make the following three contributions to existing literature. First, we offer a comprehensive description of related party transactions for a sample of 112 publicly traded companies in fiscal years 2000 and 2001, a period that predates Sarbanes-Oxley (SOX). We select our sample from COMPUSTAT, controlling for size and industry and the availability of EXECUCOMP data. We hand collect data on related party transactions from both the proxy statements and the 10-K's of each company in the sample. We present a detailed description of these transactions, including number, types, amounts, and parties involved. The detailed description of

related party transactions allows us to examine whether these transactions are limited to a few high-profile cases or widespread in the U.S. corporate sector.

Second, we investigate corporate governance mechanisms associated with related party transactions. We consider the presence and the extent of related party transactions as a corporate governance choice similar to the choice of board size or independence (Yermack, 1996; Weisbach 1998; Klein 2002a).⁵ Our research is also analogous to those studies where managerial ownership is a choice variable (for example, Demsetz and Lehn 1985; Himmelberg, Hubbard and Palia 1999). We similarly view the existence and extent of related party transactions as a choice variable. We explore whether this choice is associated with other features of the corporate governance environment such as CEO compensation, board characteristics, firm leverage, and ownership of large shareholders. We examine CEO compensation as an indicator of managers' incentive alignment. The board characteristics we investigate are board size, the percentage of insiders, dual CEO/Chair position and board compensation. We also investigate the role of large shareholders and leverage -- both of which represent external monitoring -- expecting that external monitors have limited information about the underlying nature of the related party transaction and thus prefer fewer such transactions. Additionally, we separately examine related party transactions with executives and those with non-executive board members.

Third, we investigate the association of related party transactions with firm value. If related party transactions are efficient transactions, we would not expect the market value to be negatively impacted. However, if related party transactions are conflicts of interest that are harmful to investors, we would expect a negative association with firm value. After first investigating the relationship between corporate governance and related party transactions, we further examine the degree to which related party transactions have an independent effect on industry-adjusted returns.⁶

We find the following three major sets of results.

First, we report on the prevalence and types of related party transactions. In our sample, we find that related party transactions are wide spread in fiscal years 2000 and 2001. Specifically, we find that over 80% of companies disclose at least one related party transaction, with approximately 10% of our sample reporting 10 or more. We also find that the median number of related party transactions is two, with a wide range, from 0 to 20 transactions. Of the total 878 transactions, we find that about 23% (200 transactions) are loans to executives or board members, while the rest are primarily transactions such as purchases of goods and services from executives or board members, or direct or employment services. Interestingly, there are more than three times as many transactions that are not loans as there are loans, which are the subject of SOX regulations.⁷ For the companies that report at least one related party transaction, the mean (median) dollar amount of all a company's related party transaction is \$21.0 (\$3.6) million. While small relative to a company's market capitalization, the mean amount of related party transactions is a multiple of an executive's compensation and a board member's fees. Additionally, we find that transactions are as prevalent with executives as with non-executive board members, with the two categories each representing approximately 47% of the transactions.

Second, we find that industry-adjusted returns are negatively associated with number of related party transactions (scaled by the number of named executives and board members) and their dollar amounts. When we examine the number of transactions with executives and with non-executive directors, this result holds for both, although we find a stronger negative relationship for non-executive directors. When we examine the dollar amount of transactions with executives and with non-executive directors, this result holds only for executives. After controlling for the existence of corporate governance mechanisms (such as board characteristics, CEO pay-performance sensitivity, and outside monitors), we find independent negative effects of the number of non-executive directors' and the dollar amount of executives' related party transactions on industry-adjusted returns. The number rather than the dollar amount of related party transactions being

significant for non-executives is consistent with the concept of director independence. The existence, rather than the amount, of a transaction classifies a non-executive as non-independent. For executives, however, the amount of the related party transactions appears to be more relevant than their presence.

On examination of loans versus other types of related party transactions, we find a strong negative relationship between industry-adjusted returns and loans when we examine both the number and dollar amount of related party transactions. We also find a strong negative relationship between industry-adjusted returns and the number of other types of related party transactions for non-executives. When we eliminate the effect of other corporate governance mechanisms, we find an independent negative effect for both the number and dollar amounts of loans to executives and non-executives. For non-executives, we also find that the number of all other types of transactions is negatively associated with industry-adjusted returns.⁸ These other types of transactions are not explicitly considered by SOX regulations.⁹

Third, consistent with the results of the industry-adjusted returns tests that imply these transactions are harmful to shareholders, we also find evidence of correlations between measures of corporate governance strength and related party transactions that generally imply conflict of interest. Specifically, we find that large shareholder ownership, a smaller board, fewer insiders, separate CEO-Chairman position, higher director fees, and directors awarded stock are associated with fewer and lower amounts of related party transactions with executives. In the case of non-executive directors, we find a smaller board, higher director fees, directors awarded options, and higher leverage are associated with fewer related party transactions. Smaller boards and higher leverage are also associated with lower dollar amounts of related party transactions with non-executives. These results provide evidence for agency conflict reduction. However, we find a positive association between CEO option sensitivity and CEO share ownership (CEO share ownership) for the number of (amount of) RPTs with executives suggesting an efficiency argument.

Taken together, the results from the corporate governance mechanisms tests and the industry-adjusted returns tests indicate that shareholders do not benefit from, and in fact are harmed by related party transactions, showing strong support for the conflict of interest hypothesis. This effect is especially strong for loans to executives and non-executives (now prohibited under SOX) and the number of other transactions with non-executive directors, namely purchases of goods and services and direct services.

The remainder of the paper proceeds as follows: We describe the alternative hypothesis on related party transactions in section 2. In section 3 we summarize reporting requirements for related party transactions. We describe sample creation, data collection procedures and related party transactions in section 4. We present our research design for economic determinant tests and industry-adjusted returns tests in section 5. In section 6, we present our analyses and results. We offer conclusions and extensions in section 7.

2. Two Alternative Hypotheses on Related Party Transactions

In this section, we probe the contrasting hypotheses of related party transactions as conflicts of interest or efficient transactions, and the implication for corporate governance. The conflict of interest hypothesis and potential for impropriety is demonstrated in highly publicized corporate scandals including Enron, Adelphia, and Tyco.¹⁰ There are also other less widely publicized cases. For instance, shareholders filed a lawsuit in September, 2003 that accuses Reckson Associates Realty Corp.'s main executives of self-dealing in agreeing to sell Reckson's industrial portfolio to the founding Rechler family. The lawsuit also names all of the company's outside board members, claiming that the independent directors who reviewed the plan "are so entangled with the Rechler family that their review is rendered meaningless" (Bloomberg News; Alan J. Wax, September 30, 2003).

Scandals highlight extreme examples of probable abuses of transactions with executives and board members. In general, the view that related party transactions represent a conflict of interest is consistent with agency issues similar to those considered by Berle and Means (1932) and Jensen and Meckling (1976). Jensen and Meckling (1976, 313) portray the agency conflict between a manager and outside shareholders as the manager's tendency to appropriate the firm's resources for personal consumption, like perquisites. As such, related party transactions present the potential for the expropriation of the firm's resources. To control potential agency costs, companies can use various corporate governance mechanisms to better align the interests of managers and owners, including CEO compensation and board structure. If related party transactions are conflicts of interest that arise because of the lack of alignment of managers' (or boards') incentives with shareholders, or because of limited internal monitoring, we expect that weaker governance structures will be positively associated with related party transactions.

The alternative view to the conflict of interest hypothesis is that related party transactions are efficient transactions that rationally fulfill economic demands of a company, such as securing in-depth skills and expertise or providing alternative forms of compensation. For example, say a non-executive director possesses an extensive knowledge of firm-specific activities as well as an expertise that the company demands such as legal expertise. The company engaging the related party to provide the service could be more effective than hiring an outsider. Because the non-executive director possesses an extensive knowledge of the firm, information asymmetries are reduced and contracting enhanced. Not only is the company acquiring the needed services, but engaging the director to provide the services can solidify the director's economic bond to company and escalate the director's commitment. Indeed, many companies report that their contracts with related parties have been made on terms at least as favorable as with unrelated parties.¹¹ For example, a recent Wall Street Journal article points out “a company might want the head of a key supplier as a director in order to get that person's business insights. ... some argue, a ban on related-party dealings could

deprive a company of talented employees or beneficial business arrangements” (*Wall Street Journal*, December 29, 2003, A.19.).

Under the efficient transactions hypothesis, then, a firm engaging in related party transactions would not need to incur monitoring and there would be no adverse impact on shareholders. In fact, monitoring *benefits* could arise from greater trust in dealing with family members or longer-term relationships. However, even if related party transactions are genuinely efficient transactions, a company can choose to increase monitoring to avoid the appearance of conflicts of interest and potential agency costs. If this were the case, we would expect a positive association between stronger corporate governance and related party transactions. The stronger governance is a check on the potential expropriation of a firm's assets.

While companies do not consistently disclose whether or how they monitor related party transactions, the monitoring function naturally falls under the board's responsibilities. Some firms require independent members of the board's audit committee or corporate governance committee to approve related party transactions. For instance, a list of audit committee responsibilities might include “review related party transactions between the Company and its officers, directors and key employees and any of their affiliates” (Allied Healthcare International Inc., Pre 14A, June 23, 2004. From www.sec.gov.) Another type of disclosure made by companies is that “all such transactions, investments and loans are on terms no less favorable to [the company] than could be obtained from unrelated parties” (FSF Financial Corp, Pre 14A, June 23, 2004. From www.sec.gov.)¹²

Also consistent with the view that related party transactions do not harm the interests of shareholders, arguments have been made that the amount of the transactions is small and not material to companies. Therefore, even if some agency conflict potentially exists, it is of little concern to shareholders. Despite these arguments, related party transactions are being questioned even at companies that have not been the subject of intense scrutiny, as noted in a recent Wall Street Journal article:

The dollar amounts of related-party transactions may be small, but "each of these little things is a piece of mosaic and pretty soon they form a picture," said Julie Fox Gorte, director of social research at Calvert. At Oracle, that picture is a company where the values of shareholders and executives aren't aligned, she said.

Other investors aren't alarmed by the transactions because they are publicly disclosed, and the amount of money involved is relatively small, said Bhasin, the hedge fund analyst. But most would prefer to see the practice end because of the risk that bad publicity over the deals could hurt a company's stock price.

"Even Good Insider Deals Raise Doubts." Wall Street Journal, May 7, 2003, B.6.

Consistent with this view, we regard related party transactions as important because they reflect a corporate governance choice, aside from the dollar amount. That is, the decision of whether or not to engage in, and the extent of, related party transactions is an indicator of a firm's corporate governance environment.¹³ We also consider the dollar amount of related party transactions as an indicator of the extent of any conflict of interests and amount of resources potentially expropriated. Even though the dollar amounts may be small to the firm, to an executive or board member the amounts can be significant. Figure 1 summarizes the two contrasting related party transactions hypothesis and their association with corporate governance and industry-adjusted returns.

We know of no other research that comprehensively describes and examines a large sample of firms' related party transactions. Research on director independence uses the presence of related party transactions to classify non-executive board members as "affiliated" or "grey" directors (Klein 2002a; Klein 2002b; Denis and Sarin 1999; Vicknair, Hickman and Carnes, 1993; Weisbach 1988). Typically, affiliated directors are viewed as non-independent, outside directors. Under this definition, a director is classified as non-independent given the existence of one related party transaction. Because of a difference in research focus, the grey-director classification does not explicitly consider the extent, type(s) or dollar amount of involvement, and does not reflect the breadth or source of potential conflicts of interest and the relationship with other agency conflict reducing mechanisms, as in our more detailed analysis.

Shastri and Kahle (2003) examine one type of related party transaction, loans that companies give to executives in the U.S.¹⁴ They find all loans on average to have below market interest rates, with loans for relocation being smaller and having lower interest rates than loans to purchase stock and options. They also find that the loans are beneficial (not beneficial) to low ownership (high ownership) executives to increase their ownership levels suggesting that banning loans can be harmful for low ownership executives. Our paper complements and extends theirs by examining other types of related party transactions (in addition to loans), the non-executive board members, the relationship with other corporate governance mechanisms, and the association with industry-adjusted stock returns.

In an interesting study that directly examines expropriation by majority shareholders of companies listed in Hong Kong, Cheung, Rau and Stouraitis (2004) find that excess returns in “connected transactions” are more negative when the percentage ownership of the controlling shareholder and the proxies for information disclosure are higher. Our study differs from this paper by directly examining related part transactions in the US, where the main agency issue is between managers, boards and their shareholders rather than in other countries where the problem is between majority and minority shareholders (see La Porta, et.al, 1999, and Johnson, et. al., 2000, for more detailed explanations for this distinction). Accordingly, our study complements Cheung, Rau and Stouraitis (2004) paper, by examining related party transactions in an economy with dispersed ownership concentrations.

3. Reporting Requirements for Related Party Transactions

Both SEC and FASB regulations require relatively detailed disclosure of related party transactions. Such requirements indicate a regulatory view that related party transactions are relevant to decision making by financial statement users. This relevance is predicated on the notion that certain relationships between contracting parties create the possibility for other than arms-length

transaction terms. Full disclosure of such relationships allows financial statement users to determine the implications, if any, for a firm's performance.¹⁵ This section summarizes the main FASB and SEC requirements pertaining to disclosure of related party transactions. We follow their definition and make no independent assessment in our data collection of RPTs.

FASB Statement No. 57 defines related party transactions to include transactions occurring between a company and its management, board members, principal owners, or members of the immediate families of any of these groups. Additionally, related party transactions include transactions between a company and its affiliates, where affiliates are defined as entities with any of the following relationships: they control the company; they are controlled by the company; or they are controlled by another entity which also controls the company. Related party transactions are further defined to include transactions with employee trusts or pensions, with entities in which the investment is accounted for using the equity method, and with "other parties" where a control relationship impedes each party acting in its own separate, best interest.

FASB Statement No. 57 requires that financial statements disclose all material related party transactions. Excluded from this disclosure requirement are compensation arrangements and similar arrangements occurring in the ordinary course of business. The financial statement disclosure must include the nature of the relationship, a transaction description and information on amounts involved.

SEC regulation S-X 210.4-08 (k) requires related party transactions that affect the financial statements to be disclosed in the appropriate financial statement or notes. In addition to the requirements for financial statement disclosure, SEC registrants are required by Regulation S-K Reg. §229.404 to disclose certain information on related party transactions in the non-financial statement portions of filings. Disclosure of the following relationships and related transactions are required: (a) transactions in excess of \$60,000 between the company and related persons such as board members, executives, principal owners or the families of any of these groups; (b) ownership or management relationships between directors and any entity with which the company has a business relationship

such as sales to, purchases from, loans to or borrowings from; (c) transactions with promoters; and (d) indebtedness of management to the company. Note, however, that the Sarbanes-Oxley Law (Section 402) now prohibits, in most cases, loans to directors and executives.

4. Sample Creation, Data Collection and Descriptive Analysis of Related Party Transactions

4.1. Sample Creation

Because limited prior research exists, our aim is to assess related party transactions for a broad base of publicly traded companies. A priori, we do not know the extent or types of transactions in which companies engage so we cannot simply select a sample of companies based on whether or not they engage in certain types, numbers or amounts of related party transactions. Therefore, our approach is to select a broad sample of companies, then document and analyze their related party transactions. To achieve a broad sample, we select our sample from companies in the COMPUSTAT database using stratification by industry and size. Industry groups are based on Fama and French (1997), and size is measured as quintiles of market value. We restrict the sample to firms for which COMPUSTAT includes sales, income, market value and other key data for the 2000 fiscal year.¹⁶ An initial sample of approximately 400 firms in 20 different industries, representing about ten percent of the available population, is examined to identify categories and types of related party transactions. From this group, we selected the 112 firms with compensation information on the EXECUCOMP database.¹⁷ Data on related party transactions (RPTs) is collected from SEC filings for fiscal years 2000 and 2001 for each firm, for a total of 224 firm years. Table 2 provides a description of the sample composition, indicating substantial representation across industries, consistent with our objective to achieve broad coverage of publicly-traded firms. The descriptive statistics on related party transactions in Table 2 shows variation across industry, particularly in median and maximum number of transactions, suggestive of industry effects in the number of related party transactions.

4.2. Data Collection

We hand collect data on related party transactions from both the proxy statements and the 10-K's of each company. In the proxy statements, RPTs are described in sections entitled "Certain Relationships and Related Transactions" or "Certain Company Transactions with Management" or "Certain Transactions." Also the proxy statements disclose information about family relationships, usually in the biography sections. In 10-K's, RPTs are described under Item 13, "Certain Relationships and Related Transactions", which often incorporates by reference the disclosures made in the proxy. For financial statement disclosures, footnotes, often titled "Related Party Transactions," include relevant disclosure.

We identify the disclosures in each proxy and 10-K, using a key word search supplemented by direct reading. Information in the disclosures is characterized according to the party or parties involved, the type of transaction, and the amount of the transaction, where disclosed. Each of these dimensions is described below, and examples of reported related party transaction disclosures and our classification are included in the Appendix.

Party or parties involved. Parties involved are characterized first by their relationship with the firm, such as executives, non-executive board members, principal owners, subsidiaries or other.¹⁸ In addition to these characterizations, we use further sub-categorizations because we are interested in potential conflicts of interest on the management side, potential impairment of objective monitoring by board members, and potential diminished effectiveness of boards in the presence of a dual chairman-CEO.¹⁹ The further sub-categorizations within the overall category of executive separately identify an executive chairman, executive board members and non-board executives. Within the category of non-executive board members, further sub-categorization separately identifies a non-executive chairman and non-executive board members.

Transactions may involve a family member of, or a company owned by or affiliated with, the related parties described above. In such cases, we identify both parties, characterizing the party with the most direct or senior relationship with the firm as the “primary related party.” The family member of, or the company owned by or affiliated with the related party, is characterized as the “secondary related party.” Secondary related parties are grouped by: executives, executive’s businesses, non-executives, non-executive’s businesses, principal owners, subsidiaries, and other. When the transaction is directly between the company and the primary related party (e.g. loans), no secondary related party category is required.

Type of transaction. We are interested in describing the types of related party transactions because the Sarbanes-Oxley Law now prohibits loans to executives and directors, as previously noted. In our review of company reports, we identify six main types of transactions: employment/direct services between related parties or the related party and the company; purchases of goods or services from the related party; sales to the related party; loans to or from the related party; investments; and other. Within each main type, we sub-categorize the different kinds of transactions disclosed by companies for a total of 18 different transaction types. Examples of employment/direct services include situations where a family member of the chairman serves as a non-executive director or as a company executive; or where a non-executive board member is directly employed by a principal owner. In addition to purchasing goods from related parties, firms purchase contract services from related parties including: management, legal, marketing, real estate, accounting, investment banking and other. We sub-categorize loans to related parties as loans made for house and stock purchases, where specified, and loans made for other or unspecified reasons. Another loan category includes loans from related parties such as arise, for example, in connection with debt-financed purchases from the related party. Finally, the “other” category includes transactions such as voting agreements among shareholders and shared R&D arrangements. Some

companies disclose the existence of employment agreements or indemnification agreements in related party disclosures; because these arrangements are unambiguously compensation, they are not coded.

Transaction amount. When it is disclosed, we collect information on the amounts involved in the related party transaction. For loans, investments and single transactions, we identify the amounts as principal amounts. For ongoing or multiple year involvements such as contracting services, we identify the amounts as annual amounts.

In summary, each transaction is described along four main dimensions: primary related party, secondary related party (if any), transaction type, and dollar amount.

4.3 Descriptive Analyses of Related Party Transactions

In Table 3, we provide descriptive statistics of RPT summary variables, specifically transaction counts by company overall, and then by parties involved and by transaction type. Overall, the mean (median) number of RPTs per company is 3.9 (2). In addition to these simple counts of RPTs, we believe that per company statistics on the number of different transaction per party, the number of different parties involved, and the number of different types of transactions are useful in understanding the overall complexity of the “web” of related party transactions. The mean number of RPTs per individual related party is 3.3 and 2.7 for primary and secondary related parties, respectively. The mean number of different types of related party per company is 2.1 for both primary and secondary related parties. We also find that the mean (median) number of different types of transactions per company is 2.6 (1.5) out of the 18 different transaction types we identify.

Additional details on RPTs are presented on primary related parties in Table 4, on secondary related parties in Table 5 and by type of transaction in Table 6.

Table 4 shows the number of related party transactions by company and primary related party. In total, there are 878 different related party transactions disclosed for the 112 companies (224 observations over two years) in our sample. Of the total 224 company-year observations, only 19%

disclose no related party transactions. The remaining 81% of the sample disclose at least one RPT, with the numbers ranging from 1 to 20. Executives are the primary related parties for approximately 47% of the transactions, including approximately 18%, 16% and 12% with executive chairmen, executives on the board, and non-board executives, respectively. Non-executive board members are the primary related parties for approximately 47% of the transactions, including approximately 41% and 6% with non-executive chairmen and non-executive directors, respectively. The primary related party for the remaining transactions are principal owners, subsidiaries or other affiliates.

In Table 5, we summarize transactions according to secondary and primary related parties involved. Approximately 63% of the companies have transactions directly between the company and a primary related party, such that no secondary related party is involved. Examples of such transactions are loans directly between the related party and the company, or a company purchasing some service such as legal, banking, or real estate directly from a director. Transactions directly between a company and a single related party represent approximately 41% of all related party transactions in the sample. The next highest group by secondary related party are transactions involving a director's business, which include approximately 25% of all transactions; and 35% of the companies have at least one such transaction. The third highest group includes transactions with businesses affiliated with executive chairmen, representing nearly 8% of all transactions.

Table 6 includes details on transaction type by primary related party. Several types of transactions are particularly prevalent, as evidenced by the data showing that approximately 20% of the sample firms report at least one such transaction. These particularly prevalent transaction types include: employment/direct services where an executive is one party involved; legal services purchased from a related party; real estate services, including leasing or purchasing from a related party; sales to a related party; and loans not specifically disclosed as relating to home or stock purchases. The most common type of transaction is real estate services, representing over 14% of all transactions disclosed. Other common transaction types include loans to the related party for home

purchase (over 11% of all transactions) and loans to the related party for other or undisclosed reasons (over 10% of all transactions).²⁰

Table 6 also includes information on dollar amounts of individual RPTs, where disclosed. For sales to related parties, as well as purchases of goods and contract services from related parties, amounts reported are the sum of contracts disclosed as ongoing annual contracts plus those characterized as one-time purchases or services. For loans, principal amounts are shown. We include the number in the columns under the caption ‘dollar amount of transaction’ because amounts involved are not disclosed for all related party transactions. The median amounts of loans from, purchases from, other, and investments all exceed \$3 million.

Table 7 summarizes the dollar amounts of transactions by company (as opposed to by transaction in Table 6) for only those companies with related party transactions. Amounts are presented in total for executives and non-executives and for each group separately.²¹ The mean (median) dollar amount of all a company’s related party transaction is \$21.0 (\$3.6) million. While small relative to a company’s market capitalization, the mean amount of related party transactions is a multiple of an executive’s compensation and a board member’s fees.²² We note that the sum of the dollar amount of transactions for a company has limitations. Amounts reported for certain transactions such as legal or consulting services are annual amounts (neither cumulative nor present valued) while amounts for loans are principal amounts. Additionally, certain transactions are expenses to the firm, like legal services or consulting, while other are revenues. The simplified approach of summing the dollar value of these varied transactions, though not without shortcomings, has the advantage of avoiding arbitrary aspects of estimation such as future time periods involved and appropriate discount rates.

5. Research Design: Corporate Governance Mechanisms Tests and Industry-adjusted Returns Tests

Our research design examines two questions for all related party transactions, and separately for those transactions with executives and non-executive board members. First, we ask what aspects of firms' corporate governance environments are associated with related party transactions, including the sensitivity of CEO compensation, board characteristics, leverage, and large shareholder ownership? This question implies that related party transactions are endogenously chosen. (An analogy to the determinants of managerial ownership literature of Demsetz and Lehn (1985) and Himmelberg, Hubbard and Palia (1999) is appropriate.) This set of tests is described in detail in Section 5.1 below. Second, we examine if related party transactions are positively correlated, negatively correlated, or uncorrelated with stock returns. Here, related party transactions are an independent variable in a regression where industry-adjusted stock returns are the dependent variable. This set of tests is described in detail in Section 5.2 below.²³ Given that Section 5.1 suggests that related party transactions are correlated with corporate governance mechanisms, we also remove from related party transactions their effect. Specifically, we regress related party transactions on these corporate governance mechanisms and obtain the "residual"; we then estimate the relationship between this "residual" and industry-adjusted stock returns. This approach isolates the independent relationship, if any, between related party transactions and stock returns.

5.1 Corporate Governance Mechanisms Tests

Our first empirical test evaluates whether related party transactions are associated with governance mechanisms. We view the general model of the relation as follows:

$$RPT^* = \alpha_0 + \beta_0 (Governance\ Mechanisms) + \gamma_0 (Control\ Variables) + \varepsilon \quad (1)$$

We examine three measures of number of related party transactions: 1) total number of reported related party transactions, 2) number of reported related party transactions with *executives*

and 3) number of reported related party transactions with *non-executive board members*, excluding those where an outside owner has a representative on the board. We examine transactions with executives separately from transactions with non-executive board members because of the difference in agency and monitoring roles. We scale the total number of related party transactions by the number of named executives and board members in the proxy statement. Since related party transactions are required to be reported only for these individuals, the scaling gives a measure of the extent (or pervasiveness) of a company's related party transactions.

We also consider three measures of the dollar amount of related party transactions: 1) total amount per company, 2) total amount with *executives* and 3) total amount with *non-executive board members*. We examine dollar amounts to gauge the importance to the related party, expecting that higher dollar amounts intensify any conflicts of interest. The governance mechanisms we consider are the sensitivity of CEO compensation, board characteristics and external monitoring. We discuss the motivation for each of these below.

Sensitivity of CEO compensation. The theoretical principal-agent literature has long suggested that agents (managers) be given substantial compensation that is sensitive to firm performance so that principals (shareholders) can incentivize them to work harder and choose better investment projects (Holmstrom 1979; Holmstrom and Hart 1987). Measuring the sensitivity of compensation to firm performance (i.e. “pay-performance sensitivity”). Jensen and Murphy (1990) estimated a CEO’s pay-performance sensitivity to be \$3.25 per \$1,000 increase in shareholder wealth and argue that this sensitivity is too small. However, Hall and Leibman (1998) suggest that this sensitivity is not too low, given that a small change in firm value has a large impact on shareholder wealth. Moreover, we have seen the sensitivity increase substantially in the last decade with the increasing use of stock options (Murphy 1999; Core, Guay and Larcker 2002).

A higher sensitivity implies that the CEO incentives are aligned with those of the shareholders. If related party transactions are a conflict of interest and associated with weak

governance, we expect a negative relation between sensitivity of compensation to performance and related party transactions. If related party transactions are not a conflict or are efficient transactions, the relation with sensitivity of compensation to performance will be insignificant or positive. In analyzing sensitivity of compensation to performance, we separate total compensation into the cash component, the component from options, and the component from shares owned.

Board Characteristics. We consider the relationship between related party transactions and several characteristics that have been viewed as indicators of board independence, such as board size, percent of insiders on the board and dual CEO/chair position. Prior research contends that decision-making is more effective in small boards because having fewer people enhances the group's collection, sharing and processing of information (Klein, 2002[a]; Bushman, Chen, Engel and Smith 2004; Yermack, 1996). Similarly, a smaller board's monitoring ability may be more effective. In addition to board size, board composition is viewed an indication of its monitoring effectiveness. While inside directors bring to the board expertise about the firm's activities, it is the outside directors who serve as monitors and thereby mitigate agency problems (Fama and Jensen 1983; Fama 1980). Therefore, the percent of insiders on the board is viewed as an indicator of board non-independence. The greater the percentage of insiders, the less independent the board (Klein, 2002a; Bushman, Chen, Engel and Smith 2004, Fama and Jensen, 1983). If a board is less independent, its monitoring ability is lessened. Another indicator of board independence we examine is the dual role of chairman and chief executive officer (CEO). A board that has a CEO who is also the chairman is viewed as less independent and so a weaker monitor.

The compensation of directors has also been found to correlate with firm performance, with a larger proportion of the pay-performance sensitivity coming from share and option ownership. Yermack (2003) finds that director compensation is related to firm performance. For example, Yermack (2003) finds that the wealth of outside directors changes by 6.1 cents for a \$1,000 increase in shareholder wealth (out of a total pay-performance sensitivity of 11 cents). We examine annual

remuneration of non-executive directors. Because EXECUCOMP only provides data on whether or not directors are given shares or options (not on the quantity of options and shares owned, we create two dummy variables, each set to unity if directors are given options and shares respectively.

External Monitoring. We additionally investigate the role of outside ownership and creditors as external monitors, expecting that external monitors have limited information about the underlying nature of the related party transaction and thus prefer fewer. Shleifer and Vishny (1986) argue that large shareholders play an important role as monitors of management given that they gain substantially from their large ownership stake in the firm when they expend extra monitoring effort. Hartzell and Starks (2002) find empirically that large shareholders are beneficial to monitoring of management.

Creditors, seeking to be repaid, have incentives to ensure that management and shareholders do not appropriate the assets of the firm, and thus serve an important external monitoring role (Jensen and Meckling 1976; Leftwich 1983; Watts and Zimmerman 1990).²⁴ If creditors view related party transactions as potentially decreasing the assets available to satisfy debt, they would either restrict the related party transactions allowed, or have only limited credit exposure to firms with such related party transactions. Therefore, we believe that the number of related party transactions should decrease with the firm's leverage, which we measure as the debt-to-asset ratio.

Control Variables. We include firm-specific variables to control for firm size, profitability, growth opportunities, fiscal year and industry. Size, profitability and research and development expenses are general control variables associated with a number of factors such as risk and growth. Variations in industry structure may be associated with different types of RPTs. For example, in industries requiring executives with highly technical skills, it may be less common to find [surviving] firms where the boss's family members work as executives. As another example, non-asset intensive industries can logically be expected to have fewer real estate related RPTs. We have no expectation on the signs of control variables.

To summarize, the full model we estimate is as follows:

$$\begin{aligned}
 RPT^* = & \alpha_o + \beta_1 CEO\text{CashPay} + \beta_2 CEO\text{Options} + \beta_3 CEO\text{Equity} \\
 & + \beta_4 \#BOD + \beta_5 \%Insiders + \beta_6 Dual + \beta_7 \text{Log}(\text{DirFee}) + \beta_8 \text{DirStock} + \beta_9 \text{DirOptions} \\
 & + \beta_{10} \text{LargeOwner} + \beta_{11} \text{Leverage} \\
 & + \gamma_1 \text{Log}(\text{Sales}) + \gamma_2 \text{EBITDA} + \gamma_3 R \& D / \text{Sales} + \gamma_4 \text{Year} + \sum_{i=5}^{10} \gamma_i \text{Industry} + \varepsilon
 \end{aligned} \tag{2}$$

where:

*RPT** = the number or dollar amount of related party transactions. For the number, we examine three measures: 1) total number of reported related party transactions divided by the number of named executives and directors reported by the company, 2) total number of reported related party transactions with *executives* divided by the number of named executives and directors reported by the company or 3) number of reported related party transactions with *non-executive board members* excluding those where an outside owner has a representative on the board divided by the number of named executives and directors reported by the company. For the dollar amount we also examine three measures: 1) log of a company's total dollar amount of related party transactions, 2) log of a company's total dollar amount of related party transactions with executives, or 3) log of a company's total dollar amount of related party transactions with non-executives,²⁵

CEO CashPay = sensitivity of annual cash compensation: Salary + Bonus + Other Annual Cash. Estimated as the change in annual cash compensation during the year divided by the change in market value during the year,

CEO Options = sensitivity of value of stock-based grants during the year (stock options and restricted stock) and unexercised stock options, estimated as the number of shares that could be purchased currently using the value of this year's stock option grants and unexercised options, divided by total shares outstanding. Value of stock options on the date of the grant was determined using Black-Scholes option pricing model and data from EXECUCOMP. To estimate the value of unexercised stock options we use the Black-Scholes option pricing model, making the following assumptions similar to Core and Guay (2002). The average exercise price of exercisable options is set to be the difference between the stock price and the ratio of the value of exercisable in-the-money options to the number of unexercised exercisable options, and the term to maturity of the exercisable options is set to be 3 years less than that of the new option grant (or 6 years if no new grant was made in that particular year). The average exercise price of the unexercisable options is set to be the difference between the stock price and the ratio of the value of unexercisable in-the-money options to the number of unexercisable options, and the term to maturity of the unexercisable options is set to be 1 year less than that of the new option grant (or 9 years if no new grant was made in that particular year),

CEO Equity = sensitivity of value of shares held by the CEO, estimated as the total shares held by the CEO divided by total shares outstanding,

BOD = number of board members,

% Insiders = percentage of executives on the board,

Dual = an indicator variable equal to 1 if the chairman is also an executive of the company and 0 otherwise,

Log(DirFee) = the annual cash retainer fee paid to board non-executive members,²⁶
DirStock = an indicator variable equal to 1 if company gave stock to directors and 0 otherwise,
DirOptions = an indicator variable equal to 1 if company gave stock options to directors and 0 otherwise,
% Large Owners = total percentage of shares owned by large outside owners,
Leverage = leverage estimated as total liabilities divided by total liabilities plus total shareholders' equity at the beginning of the fiscal year,
Log(Sales) = log of sales during the fiscal year,
EBITDA = earnings before interest, taxes, depreciation and amortization divided by beginning total assets,
R&D/Sales = research and development expense divided by net sales,
Year = indicator variable equal to one if the fiscal year is 2000 and 0 otherwise and,
Industry = indicator variables for each one-digit SIC industry code.

Firm- and time-subscripts are omitted from this and all equations.

Table 1 further describes variables and sources for data.

CEO CashPay, *CEO Options* and *CEO Equity* are included as measures of CEO incentive alignment. *# BOD*, *% Insiders* and *Dual* are board characteristics, typically considered indicators of weak governance. We also include in board characteristics *Log(DirFee)*, *DirStock*, and *DirOptions* as indicators of the board incentive alignment. *% Large Owners* and *Leverage* represent the extent of external monitoring. *Log(Sales)* and *EBITDA* are controls for size and profitability. We also control for *Year* and *Industry*. We have no expectation on the signs of control variables.

If related party transactions are conflicts of interest, we expect an association between weaker governance and more transactions. In this case, the estimated coefficients on *CashPay*, *CEO Options*, *CEO Equity*, *Log(DirFee)*, *DirStock*, *DirOptions*, *% Large Owners* and *Leverage* would be negative while those on *# BOD*, *% Insiders* and *Dual* would be positive. If related party transactions are efficient transactions, we would expect either stronger governance associated with more related party transaction (indicating increased monitoring to avoid appearances of conflict) or no relation with corporate governance.²⁷

We estimate the full model including all governance variables. Because of the high percentage of observations with the dependent variable equaling zero and because the number of related party transactions is bounded by zero, we use Tobit to estimate equation (2).

5.2 Industry-Adjusted Returns Tests

We next investigate whether related party transactions are associated with market values by estimating the following model:

$$\text{Industry - adjusted Return} = a_o + \phi_1 RPT^* + \lambda_1 \text{Log}(\text{Sales}) + \lambda_2 \text{EBITDA} + \lambda_3 \text{R \& D / Sales} + \lambda_4 \text{Year} + \sum_{i=5}^{10} \lambda_i \text{Industry} + e \quad (3)$$

where:

Industry-adjusted Return = annual adjusted return, from three months after year-end, using the value-weighted Fama-French 48-industry return indices.

If related party transactions are viewed by the market as conflicts of interest that harm shareholders, we expect a negative association between related party transactions and industry-adjusted returns. If related party transactions are viewed as efficient transactions that do not harm, and perhaps even benefit shareholders, we expect no relation or a positive relation with industry-adjusted returns.

The regression specification in equation (3) examines whether related party transactions are correlated with stock returns. But equations (1) and (2) suggest a possible relation between related party transactions and corporate governance mechanisms. In such instances, one might argue that equation (3) might be picking up only the effect of corporate governance mechanisms that are correlated with related party transactions, and thus any apparent significance of related party transactions could not be viewed as an independent effect. In order to obtain the independent effect of related party transactions on stock returns, we estimate the following regressions. We first estimate

the portion of related party transactions associated with corporate governance mechanisms using equation (4) below:

$$\begin{aligned}
 RPT^{*} = & \alpha_0' + \beta_1' CEOCashPay + \beta_2' CEOOptions + \beta_3' CEOEquity \\
 & + \beta_4' \#BOD + \beta_5' \%Insiders + \beta_6' Dual + \beta_7' \text{Log}(\text{DirFee}) + \beta_8' \text{DirStock} + \beta_9' \text{DirOptions} \\
 & + \beta_{10}' LargeOwner + \beta_{11}' Leverage \\
 & + RESIDUAL
 \end{aligned} \tag{4}$$

The residual from equation (4) is our proxy for the independent effect of related party transactions. We then substitute the residual into the industry-adjusted return equation as follows:

$$\begin{aligned}
 \text{Industry - adjusted Return} = & a_0' + \phi_1' RESIDUAL \\
 & + \lambda_1' \text{Log}(\text{Sales}) + \lambda_2' EBITDA + \lambda_{33}' R \& D / \text{Sales} + \lambda_4' \text{Year} + \sum_{i=5}^{10} \lambda_i' \text{Industry} + e'
 \end{aligned} \tag{5}$$

If related party transactions are viewed as conflicts of interest that harm shareholders independent of the corporate governance mechanisms in place, then RESIDUAL will be negatively related to industry-adjusted returns. If related party transactions are viewed as efficient transactions that do not harm shareholders, we expect no relation or a positive relation between RESIDUAL and industry-adjusted returns.

Similar to the corporate governance mechanisms model, we estimate equation 4 and 5 for the number and amount of all related party transactions, and then for those with executives only, and those with non-executive board members only.

6. Descriptive Statistics and Results of Corporate Governance Mechanisms and Market-based Tests

6.1 Descriptive Statistics

Descriptive statistics for variables used in the corporate governance mechanisms test are provided in Table 8.²⁸ RPT indicates that on average (at the median) related party transactions scaled

by of named executives and non-executive board members are about 25% (18%); i.e. on average there is one transaction for every four named executives and non-executive board members. As previous tables suggest, the number of related party transaction is split almost evenly into transactions with executives and non-executive board members. (The dollar amounts of RPTs are reported in Table 7). Descriptive statistics of governance characteristics suggest that our sample is representative and consistent with other studies. Sensitivities of *CEO CashPay* and *Options Granted* are consistent with previous studies (Jensen and Murphy 1990). Means and medians of board characteristics, like *#BOD*, *% Insiders*, and *DirFee* are also similar to those in other studies (Bushman, Chen, Engel and Smith 2004; Dennis and Sarin 1999; Yermack 2003).

6.2 Analyses of the Number of Related Party Transactions

6.2.1 Results of Corporate Governance Mechanisms Tests

Table 9 presents results of corporate governance mechanisms tests for the number of all related party transactions, those with executive and those with non-executives. Results provide the following evidence of an association between more RPTs and weaker corporate governance mechanisms: the negative coefficient on *Log(DirFee)*, *DirStock* and *% Large Owners*; and the positive coefficient on *% Insiders*.²⁹ In other words, these results suggest that stronger corporate governance -- alignment of board incentives and the presence of external monitors -- reduce related party transactions. Results (unreported) show no significant industry effects.

Results of the corporate governance mechanisms analysis for related party transactions involving executives again indicate evidence of an association between (fewer) more RPTs and (stronger) weaker corporate governance. The negative coefficients on *Log(DirFee)*, *DirStock* and *% Large Owners* imply these indicators of strong corporate governance (alignment of board incentives and external monitoring) reduce executive related party transactions. Similarly, the positive coefficients on, *#BOD*, *% Insiders* and *Dual*, all indicators of weak governance, are associated with

more executive related party transactions. However, *CEO Options* and *CEO Equity* are both positively associated with executive related party transactions, suggesting an efficiency argument. An alternative managerial entrenchment explanation is that managers with high levels of ownership are maximizing their private benefits of control at the expense of their shareholders (for example, Mørck Shleifer and Vishny 1988, McConnell and Servaes 1990, and Hermalin and Weisbach 1991). Although these studies point to a non-monotonic relationship between value-maximization and managerial ownership, substantial differences exist as to the shape of the relationship and the inflection point (or points) when it turns negative or positive. Accordingly, we are unable to use any prescribed ownership level to explicitly suggest that these managers who indulge in RPTS are entrenched, although our results are generally consistent with such an argument. Results also show a significantly positive industry effects (unreported) in the Transportation and Communication, and Retail and Wholesale industries.

Results of the corporate governance mechanisms analysis for related party transactions with non-executive board members are included in Table 9. The positive coefficient on *# BOD* shows a larger board (an indicator of weak governance) is associated with more related party transactions with non-executive board members. *Log(DirFee)* and *DirOptions*, both measures of stronger corporate governance, are associated with fewer RPTs, implying incentive alignment reduces related party transactions with non-executive board members. The negative coefficient on *Beg. Lev.* implies that greater external monitoring is associated with fewer RPTs. Unlike in the analyses of related party transactions with executives, we find no industry effects (unreported).

6.2.2 Results of Industry-Adjusted Returns Tests

Results of industry-adjusted returns tests, presented in Table 10, Panel A, suggest that related party transactions are viewed as conflicts of interest by the market. We find a negative association between industry-adjusted returns and total related party transactions, those with executives and those

with non-executive board members. Of our control variables, *EBITDA* is positive suggesting higher returns for more profitable firms; *R&D/Sales* is positive indicating firms with growth opportunities have higher returns; and *Year* is positive suggesting sample firms experience somewhat higher excess return in 2000.³⁰

Results in Table 10 Panel B, show an independent negative effect of related party transactions on industry-adjusted returns, even after considering corporate governance mechanisms. This relation is driven by non-executive board members' related party transactions. It appears that despite other governance mechanisms, the market still views related party transactions as conflicts of interest. The magnitude of the RESIDUAL coefficient is less negative than results in Table 10, Panel A, suggesting that the other corporate governance mechanisms reduce some, but not all, conflicts of interest in related party transactions.

6.2.3 Extensions of Industry-adjusted Returns Test

Because Sarbanes-Oxley specifically prohibits loans to executives and directors, we examine the association between industry-adjusted returns and loans separately from other types of related party transactions. As shown in Table 11, Panel A, loans are negatively associated with industry-adjusted returns overall and for both executives and non-executive board members.³¹ Other types of related party transactions are negatively associated with industry-adjusted returns overall and for non-executive board members. As shown in Table 11, Panel B, after controlling for other corporate governance mechanisms, the negative relations remain. The less negative value of the RESIDUAL coefficient suggests that other corporate governance mechanisms have reduced but not eliminated the impact of RPTs on industry-adjusted returns. The negative association between industry-adjusted returns and other types of RPTs indicates inadequately monitored conflicts of interests; and therefore other types of RPTs, aside from loans, require additional scrutiny.

6.3 Analyses of the Amount of Related Party Transactions

6.3.1. Results of Corporate Governance Mechanisms Tests

Table 12 presents results of corporate governance mechanisms tests for the amount of all related party transactions, those with executive and those with non-executives. Results provide the following evidence of an association between more RPTs and weaker corporate governance mechanisms: the negative coefficient on *Log(DirFee)* and *DirStock* and the positive coefficient on *#BOD*.³² Similar to results using the number of RPTs as the dependent variable, these results suggest that stronger corporate governance -- alignment of board incentives -- reduces related party transactions. Results (unreported) show no significant industry effects.

Results of the corporate governance mechanisms analysis for related party transactions involving executives again indicate evidence of an association between (smaller) larger amounts of RPTs and (stronger) weaker corporate governance similar to those for the number of RPTs. The negative coefficients on *Log(DirFee)*, *DirStock* and *% Large Owners* imply these indicators of strong corporate governance (alignment of board incentives and external monitoring) reduce executive related party transactions. Similarly, the positive coefficients on, *#BOD*, *% Insiders* and *Dual*, all indicators of weak governance, are associated with more executive related party transactions. However, *CEO Equity* is positively associated with executive related party transactions, suggesting an efficiency argument. Results also show a significantly positive industry effects (unreported) in the Transportation and Communication, and Retail and Wholesale industries.

Results of the corporate governance mechanisms analysis for related party transactions with non-executive board members are included in Table 12. The positive coefficient on *# BOD* shows a larger board (an indicator of weak governance) is associated with higher amounts of related party transactions with non-executive board members. The negative coefficient on *Beg. Lev.* implies that greater external monitoring is associated with lower amounts of RPTs. Unlike in the analyses of

related party transactions with executives, we find no industry effects in the board regression (unreported).

6.3.2. Results of Industry-Adjusted Returns Tests

Results of industry-adjusted returns tests, presented in Table 13, Panel A, suggest that related party transactions are viewed as conflicts of interest by the market. We find a negative association between industry-adjusted returns and total amount of related party transactions, and those with executives. Of our control variables, *EBITDA* is positive suggesting higher returns for more profitable firms; *R&D/Sales* is positive indicating firms with growth opportunities have higher returns; and *Year* is positive suggesting sample firms experience somewhat higher excess return in 2000.³³

Results in Table 13 Panel B, show an independent negative effect of the amount of related party transactions on industry-adjusted returns, even after considering corporate governance mechanisms. This relation is driven by executive board members' related party transactions. It appears that despite other governance mechanisms, the market still views the amounts of related party transactions as conflicts of interest.

Interestingly, we find the number rather than the dollar amount of related party transactions is significant for non-executives but the dollar amount of RPT is significant for executives. We view these findings as being consistent with the concept of director independence. The existence, rather than the amount, of a transaction renders a non-executive as non-independent. Therefore, the number of RPTs is significant. Knowing the dollar amount does not add incrementally to the perception of a conflict for a firm's monitor. Executives are not subject to the same independence considerations as board members, so the number of transactions does not alone suggest a conflict. For executives, the amount of the related party transactions appears to be more relevant than solely their presence.

6.3.3 Extensions of Industry-adjusted Returns Test

Table 14, Panel A, the dollar amount of loans is negatively associated with industry-adjusted returns overall and for both executives and non-executive board members.³⁴ The dollar amount of other types of related party transactions is not associated with industry-adjusted returns. As shown in Table 14, Panel B, after controlling for other corporate governance mechanisms, the negative relations remain.

7. Conclusions

Public accountants, regulators, stock market participants and other corporate stakeholders express concern about related party transactions. Yet, little rigorous academic research describes the extent of related party transactions in companies or investigates their underlying nature. In our paper, we probe two contrasting hypotheses of related party transactions that are consistent with rational economic arguments. Under the conflict of interest hypothesis, related party transactions compromise management's agency responsibility to shareholders or a board of director's monitoring function. The alternative view, which we refer to as the efficient transactions hypothesis, is that related party transactions efficiently meet the economic needs of the company. We investigate the underlying nature of related party transactions through presenting a comprehensive description of related party transactions for a large representative sample of companies, analyzing the corporate governance mechanisms of related party transactions, and examining the impact of related party transactions on firm value.

Our research offers three main findings to the extant literature. First, our descriptive analysis of related party transactions shows that they are wide spread and equally as common with executives as with non-executive board members. Loans are prevalent, but other types of transactions such as purchases or direct services are three times as common. Second, when we examine the relations between RPTs and corporate governance mechanisms (CEO pay-performance sensitivity, board characteristics, and outside monitors), we generally find evidence that implies conflicts of interest.

Third, we also find that industry-adjusted returns are negatively associated with the number and dollar amount related party transactions. When we examine the number of transactions with executives and with non-executive directors, this result holds for both, although we find a stronger negative relationship for non-executive directors. When we examine the dollar amount of transactions with executives and with non-executive directors, this result holds for only executives. After considering the existence of other corporate governance mechanisms, we find an independent negative effect of non-executive directors' related party transactions on industry-adjusted returns. On further examination of loans versus other types of related party transactions, we find an independent negative effect for both the number and dollar amounts of loans to executives and non-executives. For non-executives, we also find that the number of all other types of transactions is negatively associated with industry-adjusted returns.

In summary, the evidence indicates that shareholders do not benefit from, and in fact are harmed by some related party transactions. Our investigation of the corporate governance mechanisms associated with related party transactions and their impact on firm value supports the hypothesis that they are conflicts of interest between managers/board members and their shareholders. We find that this effect is especially strong for loans and the number of transactions (other than loans) with non-executive directors, the latter of which is not considered in Sarbanes-Oxley. Therefore, it appears that concerns among regulators and stock market participants about related party transactions are warranted. These results are generally consistent with those of Cheung, Rau and Stouraitis (2004) who examine Hong Kong listed companies.

Our conclusions are subject to two main caveats. First, while representative, our sample covers only two years. A sample over a longer time period could provide other insights. Second, as we mention in the paper, summing the dollar amounts for dissimilar transactions has limitations. Yet, when we examine dollar amounts, especially those for similar loan transactions, we find significant results. We view this paper as a starting point in comprehensively examining related party

transactions' associations with corporate governance and firm value. Future research could explore the association between related party transactions and a firm's long-run performance (similar to Gompers, Ishii, and Metrick 2003) and whether related party transactions are associated with properties of financial reports or introduce incentives for earnings management (Bushman and Smith, 2001; Sherman and Young 2001). Further, one might also examine whether these types of transactions are equally or more prevalent in other developed and emerging market economies with similar conflict of interest results – or, in some cases, are shareholder wealth-maximizing.

Endnotes

¹ A related party can also be a subsidiary, a joint venture partner, or a family member of, or a company owned by or affiliated with, any of the related individuals. Reporting guidelines on related party transactions are summarized in Section 3 of this paper.

² The American Institute of Certified Public Accountants' publication entitled, "Accounting and auditing for related parties and related party transactions,"(2001) gives three reasons why related parties and related party transactions are difficult to audit: 1.) transactions with related parties are not always easily identifiable, 2.) the auditor relies primarily upon management and principal owners to identify all related parties and related party transactions and 3.) such transactions may not be easily tracked by a company's internal control. Johnstone and Bedard (2004) include the existence of related party transactions in their audit risk measure.

³ Section 402 of Sarbanes-Oxley Law (SOX) limits the types of related party transactions in which companies can engage, prohibiting personal loans to executives and directors. Legislators, regulators and standard setters are additionally considering even more rigorous controls on related party transactions. See "RESTORING TRUST," Report to The Hon. Jed S. Rakoff, The United States District Court for the Southern District of New York, On Corporate Governance for the Future of MCI, Corporate Monitor, August 2003, Richard C. Breeden, From the SEC website (www.sec.gov). Also refer to several business press articles that discuss these concerns including "Business Ties: Many Companies Report Transactions With Top Officers" Wall Street Journal, December 29, 2003 A.1, "Even Good Insider Deals Raise Doubts." Wall Street Journal, May 7, 2003 B.6, and "Equity Office Faces Move on Related-Party Deals" Wall Street Journal, May 14, 2003. C.13.

⁴ See Section 2 of this paper for more discussion.

⁵ Like research on board size and independence, we also examine correlations between RPTs, firm value and other governance mechanisms. We do not presume causal relationships. Further, because RPTs are potentially one indicator of a firm's governance environment, we control for other corporate governance mechanisms in our market tests.

⁶ An alternative question and research design is whether the market reacts to the announcement of individual related party transactions. Consistent with the board size and independence literature, we view RPTs as observable and an indicator of the firm's corporate governance environment. Accordingly, we examine the relationship between RPTs and firm value.

⁷ See Section 4.2 on Data Collection for a more complete description of the types of transactions such as transaction involving purchases (goods and services), employment or direct services and sales to related parties.

⁸ Results of returns tests are quantitatively similar when we estimate market-adjusted returns using the value-weighted index of NYSE and AMEX returns except that total *executive* related party transactions are no longer significantly negatively related to market-adjusted returns.

⁹ Our sample period pre-dates Sarbanes-Oxley eliminating any possibility that the law precluded such transactions in our sample period.

¹⁰ See the following business press articles for detail on these companies, "Former Tyco Executives Are Charged --- New York Prosecutors Say Ex-CEO, Finance Officer Ran `Criminal Enterprise.'" Wall Street Journal, September 13, 2002; "Government Arrests Founder of Adelphia, Two Sons." Associated Press Newswires, July 25, 2002; "What Was Enron?" Editorial, Wall Street Journal, December 12, 2001. A.18.

¹¹ While the underlying presumption by regulators and standard setters is that related party transactions are not arm's length transactions and some may not have occurred with an *unrelated* party, or may have occurred on different terms with an *unrelated* party, reporting standards allow companies to state that such transactions are carried out at arm's length if the claims can be substantiated (Statement of Financial Accounting Standards No. 57, paragraphs 3, 13).

¹² Executives and non-executive board members can also recuse themselves from decisions pertaining to a transaction in which they are considered a related party.

¹³ Another possibility is that firms use the dollar amount of related party transactions to directly manipulate reported income. For instance, a firm may make a sale to a related party to boost income. Ming and Wong (2003) examine the possibility of earnings management through related party transaction sales in a sample of Hong Kong listed companies.

¹⁴ La Porta, et al (2003) examine related lending *by banks to firms* in Mexico, and find such lending exists in 20 percent of all loans. These loans are given at lower interest rates, are more likely to default, and when they default, have lower recovery rates than arms-length loans. This, they argue, suggest looting by insiders from depositors and minority shareholders.

¹⁵ In addition, auditing of related party transactions is covered in various Statements on Auditing Standards (SAS) and related interpretations. In audit planning, for example, the existence of related parties and related party transactions is highlighted as a “condition that may require extension or modification of audit tests.” SAS No. 22, Planning and Supervision, (AICPA, Professional Standards, vol. 1 AU sec 311.03) as referenced in AICPA 2001. Since the focus of this paper is on disclosure for Related Party Transactions, auditing guidelines are not included.

¹⁶ Our sample is limited to non-financial and non-utility companies, companies with fiscal year-ends in December or January, and to industries with more than 50 observations.

¹⁷ We restrict our sample to those firms on EXECUCOMP due to the demanding data requirements of related party transactions and other corporate governance mechanisms that must be hand collected. Due to the nature of the EXECUCOMP coverage, this restriction weights our sample towards larger firms.

¹⁸ We additionally collect details such as the names of the related parties, and, where the related party is an individual, their title and family relationship (if any) to other related parties involved in a transaction.

¹⁹ Jensen (1993) asserts there is a diminishment of board effectiveness when a single individual serves as both chairman and CEO.

²⁰ Also see Gordon, Henry and Palia (2004) for a preliminary, partial description of the data and additional discussion of related party transactions and corporate governance.

²¹ Because we are interested in the potential conflicts of interest, we examine only those amounts where an executive or a non-executive is involved as the primary party.

²² The high mean and maximum of a company's average amount of related party transaction with executives divided by CEO compensation are attributable to a few companies with a relatively small CEO compensation.

²³ We are unable to combine the two sets of tests (of Sections 5.1 and 5.2) in one set of simultaneous equations because the existing literature does not enable us to identify *valid and strong* instrumental variables that are related to RPT and not to industry-adjusted returns, or vice-versa.

²⁴ Creditors write debt contracts to monitor management that often include accounting-based covenants, dividend payment restrictions and other limitations on management actions, including -- where considered appropriate -- restrictions on related party transactions. We do not have direct systematic evidence of covenants on RPTs. We have only anecdotal evidence of RPT restrictions in bank covenants, and usually in the context of restricting loans to minority owned subsidiaries.

²⁵ If a company reports no related party transactions, we set the log of the dollar amount to zero.

²⁶ When we include meeting fees paid to directors, results are quantitatively similar.

²⁷ We also examined whether the presence of a founder involved as a board member or named executive of the company is associated with related party transactions. The Pearson correlation between the presence of a founder and total number of related party transactions (scaled by named officers) is positive ($p=0.107$) as is the correlation with number of related party transactions with executives (scaled by named officers) ($p=0.003$). The Pearson correlation with the number of non-executive related party transactions is not significant. In unreported Tobit regressions similar to those in Table 9 and Table 12, we included an indicator variable equaling one if a founder is involved and zero otherwise. The coefficient on the indicator variable is not significant at conventional levels in five of the six regressions, providing limited evidence of a relation when other governance mechanisms are considered. When the logged total dollar amount of related party transactions is the dependent variable it is weakly negative ($p\text{-value} = 0.096$).

²⁸ We winsorize outlying non-return variables to the 5% and 95% percentile. For industry-adjusted returns, we winsorize outlying returns to -100% and 100%.

²⁹ We also estimate separate regressions for the three main governance mechanisms: sensitivities of CEO compensation, board characteristics and outside monitors. For the number of all related party transactions, results of the full regression model on all governance characteristics presented in Table 9 are consistent with separate regressions except that *CEO Equity* and *#BOD* are significant in separate regressions with p -values of 0.002 and 0.073, respectively. For transactions with executives, results on the separate sets of governance characteristics are similar to the full model. For transactions with non-executives, results on the separate sets of governance characteristics are similar to the full model except that the coefficient on *Large Owners* is significantly negative with a p -value of 0.060.

³⁰ In ordinary least squared regressions of industry-adjusted returns, we delete influential observations identified as those with an absolute value of the t -student greater than three.

³¹ Results are quantitatively similar when we examine only loans to executives or non-executive board members.

³² We also estimate separate regressions for the three main governance mechanisms: sensitivities of CEO compensation, board characteristics and outside monitors. For the log of all related party transactions, results of the full regression model on all governance characteristics presented in Table 9 are consistent with separate regressions except that *CEO Equity*, *CEO Options*, *% Insiders*, *Large Owners* and *Beg. Lev.* are significant in separate regressions with p -values of 0.090, 0.017, 0.071, 0.019, and 0.094, respectively. For transactions with executives, results on the separate sets of governance characteristics are similar to the full model except that *CEO Options* is significant with a p -value of 0.043. For transactions with non-executives, results on the separate sets of governance characteristics are similar to the full model except that the coefficient on large owners is significantly negative with a p -value of 0.104.

³³ In ordinary least squared regressions of industry-adjusted returns, we delete influential observations identified as those with an absolute value of the t -student greater than three.

³⁴ Results are quantitatively similar when we examine only loans to executives or non-executive board members.

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Figure 1

Summary of Related Party Transactions Hypothesis and Association with Corporate Governance and Industry-adjusted Returns

Association of Related Party Transactions (RPTs) with:		
Hypothesis	Corporate Governance	Industry-adjusted Returns
Conflict of Interest	Weak corporate governance is positively related to RPTs, since inadequate monitoring or misaligned incentives create an environment conducive to RPTs; or no association.	Excess industry returns are negatively associated with RPTs. A N D
Efficient Transactions	Weak corporate governance indicators are negatively associated with RPTs because firms have strengthened their corporate governance to monitor RPTs; or no association because stronger corporate governance environments have precluded RPTs.	Excess industry returns are positively or not significantly associated with RPTs. A N D

Table 1
Definition of Variables

Variable Name **Variable Definition**

Related Party Transaction Variables

<i>All RPT</i>	total number of reported related party transactions divided by the number of named executives and directors reported by the company
<i>Executive RPT</i>	number of reported related party transactions with named executives divided by the number of named executives and directors reported by the company
<i>Non-Executive Board RPT</i>	number of reported related party transactions with board members, excluding those where an outside owner has a representative on the board, divided by the number of named executives and directors reported by the company

Sensitivity of CEO Compensation

<i>CEO CashPay</i>	sensitivity of annual cash compensation: Salary + Bonus + Other Annual Cash. Estimated as the change in annual cash compensation during the year divided by the change in market value during the year.
<i>CEO Options</i>	sensitivity of stock-based grants during the fiscal year (stock options and restricted stock) and unexercised stock options estimated as the number of shares that could be purchased currently using the value of this year's stock option grants and unexercised options, divided by total shares outstanding. Value of stock options on the date of the grant was determined using Black-Scholes option pricing model and data from EXECUCOMP. To estimate the value of unexercised stock options we use the Black-Scholes option pricing model, making the following assumptions similar to Core and Guay (2002). The average exercise price of exercisable options is set to be the difference between the stock price and the ratio of the value of exercisable in-the-money options to the number of unexercised exercisable options, and the term to maturity of the exercisable options is set to be 3 years less than that of the new option grant (or 6 years if no new grant was made in that particular year). The average exercise price of the unexercisable options is set to be the difference between the stock price and the ratio of the value of unexercisable in-the-money options to the number of unexercisable options, and the term to maturity of the unexercisable options is set to be 1 year less than that of the new option grant (or 9 years if no new grant was made in that particular year).
<i>CEO Equity</i>	sensitivity of value of shares held by the CEO, estimated as the total shares held by the CEO divided by total shares outstanding.

Board and Ownership Characteristics

<i># BOD</i>	number of board members from proxy statement
<i>% Insiders</i>	percentage of executives on the board
<i>Dual</i>	an indicator variable equal to 1 if the chairman is also an executive of the company and 0 otherwise
<i>Log(DirFee)</i>	annual cash retainer fee paid to board non-executive members, from EXECUCOMP
<i>DirStock</i>	an indicator variable equal to 1 if company gave stock to directors and 0 otherwise, from EXECUCOMP
<i>DirOptions</i>	an indicator variable equal to 1 if company gave stock options to directors and 0 otherwise, from EXECUCOMP

External Monitors

<i>% Large Owners</i>	total percentage of shares owned by large outside owners (disclosed in proxy statement).
<i>Beg. Lev</i>	leverage estimated as total liabilities divided by total liabilities plus total shareholders' equity at the beginning of the fiscal year

Other Firm and Performance Characteristics

<i>Log(Sales)</i>	log of sales during the fiscal year
<i>EBITDA</i>	earnings before interest, taxes, depreciation and amortization divided by beginning total assets
<i>R&D/Sales</i>	research and development expense divided by net sales

Industry-adjusted Returns

<i>Industry-adjusted return</i>	annual adjusted return, from three months after year-end using the value-weighted Fama-French 48-industry return indices.
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Table 2Sample Industry Composition and Summary of Related Party Transactions by Industry^a

<i>Industry</i>	Companies <u>Collected</u> ^b	Sample <u>Composition</u>	Compustat <u>Population</u>	<u>Related Party Transactions</u>			
				<u>Mean</u>	<u>Median</u>	<u>Min</u>	<u>Max</u>
Entertainment	3	2.7%	1.9%	4.7	4	0	10
Consumer Goods	3	2.7%	1.9%	2.7	4	0	4
Apparel	3	2.7%	1.3%	2.7	3	1	4
Healthcare	3	2.7%	1.9%	4.7	3	1	10
Medical Equipment	1	0.9%	3.1%	2	2	2	2
Pharmaceutical Products	7	6.3%	7.0%	3.7	4	0	7
Chemicals	5	4.5%	1.9%	3	2	1	7
Construction Materials	4	3.6%	1.8%	2	1	0	6
Steel Works, etc	4	3.6%	1.6%	0.8	0.5	0	4
Machinery	6	5.4%	3.1%	3.5	0.5	0	10
Petroleum and Natural Gas	13	11.6%	4.5%	3.4	2	0	7
Telecommunications	4	3.6%	6.2%	7	7.5	3	10
Business Services	12	14.7%	19.0%	3	2	0	14
Computers	8	7.1%	4.9%	2.6	1	0	7
Electronic Equipment	6	5.4%	5.5%	3.8	1	0	15
Measuring and Control Equip	1	0.9%	1.9%	3	3	3	3
Transportation	4	3.6%	2.7%	6.5	2.5	2	19
Wholesale	6	5.4%	3.4%	3.2	3.5	0	6
Retail	15	10.4%	5.3%	7.7	7	0	18
Restaurants, Hotel, Motel	4	3.6%	2.0%	2.8	2.5	2	4
Total	112						

^a We define industries following Fama French (1997).^b We collect data on related party transactions from 112 companies for fiscal years 2000 and 2001.

Table 3

Descriptive Statistics of Related Party Transaction Summary Variables

This table provides descriptive detail on related party transactions collected for 112 companies from fiscal years 2000 and 2001 proxy statements and 10-Ks.

	<u>Mean</u>	<u>Std. Dev.</u>	<u>Median</u>
<u>Related Party Transaction (RPT) Summary Variables:</u> (n=224)			
<i>Overall -</i>			
Number of RPTs per company	3.920	4.310	2
<i>Primary Related Parties -</i>			
Number of RPTs per individual primary related party	3.288	2.518	3
Number of different types of primary related parties per company	2.055	1.068	2
<i>Secondary Related Parties -</i>			
Number of RPTs per individual secondary related party	2.686	2.745	2
Number of different types of secondary related parties per company	2.121	1.280	2
<i>Types of Transactions -</i>			
Number of different types of transactions per company	2.607	1.544	2

Table 4**Summary of Related Party Transactions by Company and Primary Related Party**

This table presents related party transactions data by the number per company and by primary related party for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 440 are reported in 2000 and 428 in 2001. The 'Percent of Transactions with:' columns report the percent out of 100% by primary party and number of transactions. Executive and non-executives columns include both current and former executives, with approximately 2% (1%) of transactions with former executives (non-executives). Subsidiary also includes transactions with joint venture partners.

					Percent of Transactions with:							
Number of Related Party Transactions			Number of Related Party Transactions		Executives			Non-Executives		Principal Owner	Subsidiary	Other
per Company	Number of Obs.	Percent of Obs.	Transactions	Percent of RPTs	Chairman	Board Member	Non-Board	Director	Chairman			
0	43	19.2%	0	0.0%	0%	0%	0%	0%	0%	0%	0%	0%
1	29	12.9%	29	3.3%	0.5%	0.8%	0%	1.5%	0%	0.1%	0.2%	0.2%
2	42	18.8%	84	9.6%	0.9%	1.9%	0.7%	4.7%	0.6%	0.7%	0.1%	0%
3	22	9.8%	66	7.5%	1.1%	1.6%	0.8%	2.5%	0.7%	0.5%	0.2%	0.1%
4	13	5.8%	52	5.9%	1.0%	1.4%	0.9%	2.1%	0.6%	0%	0%	0%
5	15	6.7%	75	8.5%	1.5%	1.7%	1.3%	2.4%	0.6%	0%	0.9%	0.2%
6	11	4.9%	66	7.5%	0.1%	1.3%	0.5%	4.0%	0.2%	0.8%	0%	0.7%
7	19	8.5%	63	7.2%	2.5%	3.2%	2.6%	3.7%	2.2%	0.3%	0.3%	0.1%
8	6	2.7%	48	5.5%	1.5%	0.3%	0.6%	2.6%	0.3%	0.1%	0%	0%
9	1	0.5%	9	1.0%	0%	0.7%	0.2%	0.1%	0%	0%	0%	0%
10	9	4.0%	90	10.3%	3.5%	0.3%	1.4%	4.0%	0.6%	0%	0.5%	0.3%
11	2	0.9%	22	2.5%	1.1%	2.6%	0%	0.7%	0.5%	0%	0%	0%
12 -20	12	5.4%	274	31.2%	4.5%	0.4%	3.2%	12.2%	0%	0%	0.4%	0%
	224	100.0%	878	100.0%	18.2%	16.2%	12.2%	40.5%	6.2%	2.5%	2.6%	1.4%
Percent of Companies with Transaction					28.1%	29.9%	21.8%	57.1%	12.9%	6.7%	5.8%	3.6%

Table 5**Summary of Related Party Transactions by Secondary and Primary Party**

This table presents related party transactions data by the number per company and by secondary related party for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 440 are reported in 2000 and 428 in 2001. The 'Percent of Transactions with:' columns report the percent out of 100% by secondary party and number of transactions. Executive and non-executives columns include both current and former executives, with approximately 2% (1%) of transactions with former executives (non-executives). Subsidiary also includes transactions with joint venture partners.

Secondary Party		Percent of Companies with Transaction (N = 224 Obs.)	Percent of Related Party Transactions (N=878 Trans.)	Primary Party Percent of Transactions with:								
				Executives			Non-Executives			Principal Owner	Subsidiary	Other
				Chairman	Board Member	Non- Board	Chairman Director	(not CEO)				
Executives -	Chairman	8.0%	3.2%	3.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Board Member	3.6%	1.0%	0.0%	1.0%	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%
	Non-Board	8.9%	3.7%	0.0%	0.0%	1.4%	1.4%	0.9%	0.0%	0.0%	0.0%	0.0%
Executive's business -	Chairman	12.5%	7.7%	7.7%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Board Member	6.3%	2.4%	0.0%	2.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	Non-Board	7.1%	3.2%	0.0%	0.1%	2.3%	0.9%	0.0%	0.0%	0.0%	0.0%	0.0%
Non-Executives -	Director	12.9%	4.8%	3.4%	0.0%	0.0%	0.5%	0.9%	0.0%	0.0%	0.0%	0.0%
	Chairman	6.3%	3.3%	0.2%	0.0%	0.0%	0.0%	3.1%	0.0%	0.0%	0.0%	0.0%
Non-Executive's business		34.8%	24.8%	0.0%	0.0%	0.2%	24.6%	0.0%	0.0%	0.0%	0.0%	0.0%
Principal Owner		4.0%	2.1%	0.0%	0.0%	0.0%	1.8%	0.0%	0.0%	0.0%	0.2%	0.0%
Subsidiary		1.8%	1.1%	0.2%	0.2%	0.1%	0.6%	0.0%	0.0%	0.0%	0.0%	0.0%
Other		1.8%	1.8%	0.0%	0.0%	0.8%	0.8%	0.2%	0.0%	0.0%	0.0%	0.0%
Not Applicable (Transaction directly with company)		63.4%	40.9%	3.4%	12.6%	7.4%	9.9%	1.0%	2.5%	2.6%	1.4%	
Total			<u>100.0%</u>	<u>18.2%</u>	<u>16.2%</u>	<u>12.2%</u>	<u>40.5%</u>	<u>6.2%</u>	<u>2.5%</u>	<u>2.6%</u>	<u>1.4%</u>	

Table 6**Summary of Related Party Transactions by Type and Primary Related Party**

This table presents related party transactions data by the number per company and by type for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 440 are reported in 2000 and 428 in 2001. The 'Percent of Transactions with:' columns report the percent out of 100% by primary party and type of transaction. Executive and non-executives columns include both current and former executives, with approximately 2% (1%) of transactions with former executives (non-executives). Subsidiary also includes transactions with joint venture partners. Amounts reported for direct service, contract services and sales are annual amounts. Amounts reported for loans are principal. Amounts are not disclosed for all transactions, and we therefore report amounts, where available.

Type of Relation	Percent of Companies with Transaction (N = 224 Obs.)	Percent of Related Party Transactions (N=878 Trans.)	Dollar Amount of Transaction (in 000s)			Primary Party Percent of Transactions with:							
			Mean	Median	N	Executives			Non-Executives ^c		Principal Owner	Subsidiary	Other
						Chairman	Member	Non-Board	Director	Chairman			
Employment/Direct Services:													
- Direct Service	4.0%	2.3%	--	-	-	0%	0.5%	0.9%	0.2%	0%	0%	0%	0%
- Direct Service-Exec	20.5%	9.6%	-	-	-	3.9%	0.2%	0%	4.4%	1.0%	0%	0%	0%
- Direct Service-Non-Exec	11.2%	4.7%	-	-	-	3.7%	0%	0%	0.4%	0.7%	0%	0%	0%
Goods or Services Provided:													
- Management Services	10.3%	4.0%	\$329	\$120	35	0.5%	1.3%	0%	1.6%	0.5%	0.2%	0%	0%
- Legal Services	20.5%	6.6%	\$441	\$157	19	0%	0%	1.0%	5.5%	0%	0%	0%	0%
- Marketing	0.4%	0.1%	\$447	\$447	1	0%	0%	0%	0.1%	0%	0%	0%	0%
- Real Estate	21.0%	14.4%	\$1,264	\$618	122	2.9%	2.0%	2.0%	6.8%	0.8%	0%	0%	0.1%
- Accounting	0.4%	0.1%	\$257	\$257	1	0%	0%	0%	0.0%	0%	0%	0%	0.1%
- Investment Banking	5.8%	1.7%	\$1,241	\$251	10	0%	0%	0%	1.3%	0%	0.5%	0%	0%
- Other	7.6%	2.8%	\$568	\$463	24	0.4%	0%	0.1%	2.1%	0.2%	0%	0%	0%
- Purchases from	21.0%	7.0%	\$15,740	\$3,177	57	1.3%	0.4%	0.5%	2.9%	0.6%	0.5%	0.7%	0.4%
Sales to Related Party	17.0%	8.9%	\$8,644	\$675	86	1.4%	0.8%	0.4%	4.2%	0.6%	0.6%	1.0%	0%
Loans:													
- Loans to - Home	15.2%	11.3%	\$1,228	\$414	99	1.0%	5.9%	3.6%	0.7%	0.1%	0%	0%	0%
- Loans to - Stock	2.7%	1.0%	\$596	\$240	9	0.2%	0.5%	0.4%	0%	0%	0%	0%	0%
- Loans to - Other	20.1%	10.5%	\$8,168	\$575	91	1.6%	3.5%	1.7%	2.9%	0.4%	0%	0.5%	0%
- Loans from	8.5%	2.7%	\$37,997	\$5,800	24	0.7%	0.3%	0.3%	0.7%	0.4%	0.4%	0.2%	0%
Investment	7.6%	5.9%	\$3,476	\$2,554	43	0.2%	0.9%	0.6%	3.6%	0.4%	0%	0.2%	0%
Other	17.0%	6.3%	\$58,294	\$3,300	23	0.4%	0.4%	0.8%	3.0%	0.2%	0.5%	0.2%	0.9%
Total		<u>100.0%</u>				<u>18.2%</u>	<u>16.2%</u>	<u>12.2%</u>	<u>40.5%</u>	<u>6.2%</u>	<u>2.5%</u>	<u>2.6%</u>	<u>1.4%</u>

Table 7

Descriptive Statistics of Firm-level Dollar Amounts of Related Party Transactions by Major Types of Transaction

Descriptive statistics are presented for *only* those companies report the type of transaction. Amount totals exclude transactions with amounts missing, amounts of direct services transactions (which are reported by few companies) and amounts of related party transactions where the principal owner, subsidiary or other is the primary party..

	Dollar Amount of Transaction (in 000s)					
	<u>N</u>	<u>Mean</u>	<u>Std. Dev.</u>	<u>Median</u>	<u>Min</u>	<u>Max</u>
<u>All Executive and Non-Executive</u>						
Goods or Services Provided	92	7,734	21,441	1,768	0.001	179,846
Sales to Related Party	26	22,594	43,475	2,250	8	141,000
Loans	74	13,992	29,423	2,166	65	120,000
Investments	13	10,989	26,060	3,000	10	94,524
Other	15	35,651	57,228	1,328	0.001	194,800
Total	144	20,961	40,297	3,567	65	217,730
Total Divided by MV	144	0.000045	0.000239	0.000003	0.000000	0.002700
<u>Executive Only</u>						
Goods or Services Provided	54	4,817	10,441	2,304	17	61,100
Sales to Related Party	12	9,206	13,806	2,250	56	34,129
Loans	61	5,432	10,397	1,100	65	50,000
Investments	6	2,399	2,042	2,590	257	5,700
Other	7	51,659	71,836	5,738	248	191,800
Total	110	9,807	25,193	2,309	38	213,900
Total Divided by MV	110	0.000022	0.000099	0.000001	0.000000	0.000941
Average per Executive Divided by CEO Compensation						
	110	2577	21931	0.310	0	168134
<u>Non-Executive Only</u>						
Goods or Services Provided	70	6,449	22,560	945	0.001	179,846
Sales to Related Party	16	29,810	48,079	7,500	8	141,000
Loans	23	30,609	44,568	5,000	175	120,000
Investments	7	18,351	34,896	3,000	10	94,524
Other	9	19,239	36,727	612	0.001	84,000
Total	96	20,204	40,305	2,087	0.001	182,259
Total Divided by MV	96	0.000042	0.000192	0.000001	0.000000	0.001760
Average per Director Divided by Director's Fees						
	96	65.95	139.35	3.93	0.00000	625.87

Table 8

Descriptive Statistics for the Number of Related Party Transactions and Sensitivities of CEO Compensation, Board Characteristics, Outside Monitors, Other Firm and Performance Characteristics Variables and industry-adjusted Returns

See table 1 for variable definitions. Descriptive statistics are presented for approximately 224 observations (112 companies for 2000 and 2001 fiscal years). For a small number of observations, variables are missing.

<u>Variable</u>	<u>Mean</u>	<u>Std Dev</u>	<u>Median</u>	<u>Percent Non-Zero RPT Obs.</u>
<u>Number of Related Party Transaction (RPT)</u> (Scaled by Named Executives and Board Members)				
<u>All RPTs</u>				
- Total	0.253	0.246	0.176	81.5%
- All Loans	0.075	0.168	0	35.8%
- Other types (not loans)	0.182	0.200	0	70.2%
<u>Executive RPTs</u>				
- Total	0.132	0.173	0.063	55.6%
- All Loans	0.059	0.155	0	36.7%
- Other types (not loans)	0.074	0.123	0	29.5%
<u>Non-Executive Board RPTs</u>				
- Total	0.117	0.149	0.071	60.9%
- Loans only	0.014	0.055	0	9.2%
- Other types (not loans)	0.103	0.125	0.071	58.6%
<u>Sensitivities of CEO Compensation</u>				
CEO CashPay	0.001	0.003	0	
CEO Options	0.009	0.009	0.006	
CEO Equity	0.026	0.045	0.005	
<u>Board Characteristics</u>				
# BOD	9.317	3.052	9.000	
% Insiders	0.234	0.134	0.200	
Dual	0.668	0.472	1	
DirFee (in thousands)	22.187	15.723	23.750	
DirStock	0.293	0.456	0	
DirOptions	0.727	0.447	1	
<u>Outside Monitors</u>				
% Large Owners	0.190	0.143	0.152	
Beg. Lev	0.532	0.195	0.547	
<u>Other Firm and Performance Characteristics</u>				
Sales (in millions)	5,714	11,736	1,093	
EBITDA	0.057	0.155	0.054	

Table 9

Tobit Regressions of Number of Related Party Transactions (Scaled by Named Executives and Board Members) on Governance Characteristics: Sensitivities of CEO Compensation, Board Characteristics and Outside Monitors.

Results of estimating equation 2. Coefficients are shown, with marginal effects to the right and p-values below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. Tests show the presence of heteroskedasticity and results are corrected for it. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Independent Variables (n=215)	Governance Characteristics					
	All RPTS		RPTs with Executives		RPTs with Non-Executives	
Intercept	0.497***		-0.159		0.319	
	0.004		0.296		0.018	
<i>CEO CashPay</i>	2.037	1.660	1.800	1.001	2.809	1.710
	0.714		0.700		0.487	
<i>CEO Options</i>	0.089	0.072	3.997*	2.222	1.063	0.647
	0.972		0.067		0.556	
<i>CEO Equity</i>	0.302	0.246	0.767**	0.426	0.098	0.059
	0.461		0.029		0.744	
<i># BOD</i>	0.009	0.007	0.012**	0.007	0.023***	0.014
	0.186		0.049		0.000	
<i>% Insiders</i>	0.236*	0.192	0.481***	0.267	-0.039	-0.024
	0.106		0.000		0.740	
<i>Dual</i>	0.043	0.035	0.077**	0.043	-0.052	-0.032
	0.266		0.027		0.112	
<i>Log(DirFee)</i>	-0.066***	-0.054	-0.055***	-0.031	-0.030*	-0.018
	0.002		0.001		0.079	
<i>DirStock</i>	-0.083*	-0.067	-0.097**	-0.054	0.025	0.015
	0.057		0.014		0.498	
<i>DirOptions</i>	-0.009	-0.007	0.049	0.027	-0.077**	-0.047
	0.836		0.185		0.033	
<i>Large Owner</i>	-0.436***	-0.355	-0.398***	-0.221	-0.206	-0.126
	0.004		0.002		0.109	
<i>Beg. Lev</i>	-0.164	-0.133	0.123	0.069	-0.192**	-0.117
	0.151		0.208		0.037	
<i>Log(Sales)</i>	-0.003	-0.003	-0.015	-0.008	-0.016	-0.010
	0.832		0.282		0.164	
<i>EBITDA</i>	2.077	1.692	0.929	0.516	1.233	0.751
	0.281		0.578		0.370	
<i>R&D/Sales</i>	0.043	0.035	-0.140	-0.078	0.266	0.162
	0.832		0.383		0.158	
<i>Year</i>	0.000	0.000	-0.016	-0.009	-0.005	-0.003
	0.999		0.606		0.851	
% RPT Variable Non-Zero	81.5		55.6		60.9	

Table 10

Ordinary Least Squared Regressions of Industry-adjusted Returns on the Number of Related Party Transactions (Scaled by Named Executives and Board Members)

Results of estimating equation 3 and equation 5. Coefficients are shown with White t-statistics below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Dependent Variable (<i>n</i> =215)	Independent Variables							Adj. R²
	Intercept	RPT*	Log(Sales)	EBITDA	R&D/Sales	Year		
Panel A: Industry-adjusted Returns Regressions (equation 3)								
<u>All Related Party Transactions</u>								
All RPTs	0.580 ***	-0.483 ***	-0.041 **	1.024 ***	0.542 **	0.153 ***		0.135
	3.113	-3.876	-2.546	3.176	2.139	2.688		
<u>Executive Related Party Transactions</u>								
Total Exec	0.467 **	-0.384 *	-0.036 **	1.078 ***	0.535 **	0.130 **		0.088
	2.451	-1.926	-2.170	3.165	2.151	2.200		
<u>Non-Executive Board Related Party Transactions</u>								
Total Non-Exec Board	0.480 **	-0.637 ***	-0.024	0.870 **	0.426 *	0.128 **		0.090
	2.475	-3.168	-1.437	2.520	1.825	2.166		
Panel B: Residual Regressions (equation 5)								
<u>All Related Party Transactions</u>								
All RPTs	0.378 **	-0.116 ***	-0.022	0.995 ***	0.381	0.127 **		0.125
	2.056	-3.809	-1.354	3.049	1.620	2.176		
<u>Executive Related Party Transactions</u>								
Total Exec	0.352 *	-0.028	-0.022	0.963 ***	0.447 *	0.114 *		0.061
	1.848	-1.003	-1.289	2.747	1.855	1.904		
<u>Non-Executive Board Related Party Transactions</u>								
Total Non-Exec Board	0.376 **	-0.064 **	-0.022	0.898 ***	0.441 *	0.122 **		0.080
	1.981	-2.442	-1.346	2.588	1.811	2.058		

Table 11

Ordinary Least Squared Regressions of Industry-adjusted Returns on the Number of Loans and Other Related Party Transactions (Scaled by Named Executives and Board Members), in Total and by Executive and Non-Executive Board Members

Results of estimating equation 3 and equation 5. Coefficients are shown with White t-statistics below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. Tests do not show the presence of heteroskedasticity and results are not corrected for it. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Dependent Variable (<i>n=215</i>)	Independent Variables									Adj. R²
	Intercept	RPT*	Log(Sales)	EBITDA	R&D/Sales	Year				
Panel A: Industry-adjusted Returns Regressions (equation 3)										
<u>All Related Party Transactions</u>										
Loans	0.400 **	-0.622 ***	-0.022	0.925 ***	0.501 **	0.092				0.104
	2.142	-4.129	-1.362	2.726	2.091	1.574				
Other RPTs	0.470 **	-0.386 **	-0.028	1.100 ***	0.431 *	0.125 **				0.089
	2.388	-2.178	-1.641	3.223	1.819	2.128				
<u>Executive Related Party Transactions</u>										
Loans	0.432 **	-1.134 ***	-0.027 *	0.902 ***	0.540 *	0.121 **				0.099
	2.375	-3.185	-1.801	2.607	2.293	2.085				
Other RPTs	0.357 *	0.032	-0.019	0.960 ***	0.466 **	0.118 *				0.057
	1.837	0.101	-1.073	2.635	1.986	1.943				
<u>Non-Executive Board Related Party Transactions</u>										
Loans	0.362 **	-1.451 ***	-0.021	0.760 ***	0.527 **	0.146 **				0.097
	1.972	-3.600	-1.277	2.144	2.168	2.500				
Other RPTs	0.446 **	-0.531 **	-0.024	1.037 ***	0.407 *	0.126 **				0.085
	2.268	-2.161	-1.419	2.994	1.781	2.121				
Panel B: Residual Regressions (equation 5)										
<u>All Related Party Transactions</u>										
Loans	0.315 *	-0.104 ***	-0.025	0.963 ***	0.518 ***	0.141 **				0.142
	1.724	-3.589	-1.634	2.895	2.868	2.497				
Other RPTs	0.370 *	-0.057 *	-0.023	1.042 ***	0.392 *	0.122 **				0.081
	1.942	-1.869	-1.374	3.022	1.728	2.065				
<u>Executive Related Party Transactions</u>										
Loans	0.345 *	-0.063 ***	-0.025	0.890 ***	0.471 **	0.120 **				0.089
	1.876	-2.506	-1.628	2.546	2.104	2.075				
Other RPTs	0.336 *	0.019	-0.011	0.932 ***	0.429 **	0.101 *				0.051
	1.753	0.636	-0.622	2.588	2.019	1.673				
<u>Non-Executive Board Related Party Transactions</u>										
Loans	0.281	-0.072 **	-0.018	0.919 ***	0.181 **	0.122 **				0.072
	1.455	-2.028	-1.110	2.625	2.018	2.042				
Other RPTs	0.369 *	-0.048 *	-0.021	0.930 ***	0.429 *	0.118 **				0.069
	1.934	-1.876	-1.272	2.632	1.776	1.992				

Table 12

Tobit Regressions of the Log of Total Dollar Amount of Related Party Transactions on Governance Characteristics: Sensitivities of CEO Compensation, Board Characteristics and Outside Monitors.

Results of estimating equation 2. Coefficients are shown with marginal effects to the right and p-values below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. Tests show the presence of heteroskedasticity and results are corrected for it. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Independent Variables (n=215)	Governance Characteristics					
	Total Amount		Total Amount with Executives		Total Amount with Non-Executive Board Members	
Intercept	6.4833		-6.1239		6.7889	
	0.0521		0.1357		0.1844	
<i>CEO CashPay</i>	-35.8511	-24.0119	82.0994	42.0043	-74.6698	-33.3409
	0.7288		0.5508		0.5974	
<i>CEO Options</i>	43.7801	29.3225	84.6794	43.3243	38.742	17.2988
	0.3963		0.1525		0.5908	
<i>CEO Equity</i>	4.0354	2.7028	16.1457	*	8.2606	-0.3886
	0.6295		0.0963		0.9413	
<i># BOD</i>	0.5686	***	0.3808	***	0.3471	***
	0.0001		0.0001		0.0001	
<i>% Insiders</i>	4.7800	3.2015	8.5315	**	4.3650	1.7073
	0.1305		0.0187		0.4383	
<i>Dual</i>	1.1774	0.7886	2.0289	**	1.0380	-0.2837
	0.1342		0.0386		0.6297	
<i>Log(DirFee)</i>	-0.7997	*	-0.5356	**	-0.5009	-0.1574
	0.0553		0.0451		0.5863	
<i>DirStock</i>	-3.0759	***	-2.0601	***	-1.9433	-0.0903
	0.0037		0.0010		0.9125	
<i>DirOptions</i>	1.5257	*	1.0219		0.8214	0.0871
	0.0924		0.1221		0.8998	
<i>Large Owner</i>	-5.0819	-3.4037	-9.5187	**	-4.8700	-1.9883
	0.1121		0.0159		0.3739	
<i>Beg. Lev</i>	-2.0161	-1.3503	2.4190		1.2376	**
	0.3994		0.3954		0.0199	
<i>Log(Sales)</i>	-0.3369	-0.2256	-0.2801		-0.1433	***
	0.287		0.4673		0.0017	
<i>EBITDA</i>	11.7955	7.9002	35.963	18.3997	0.5108	0.2281
	0.7605		0.4383		0.9925	
<i>R&D/Sales</i>	-8.3796	*	-5.6124	-6.7726	-3.4651	-2.4536
	0.0402		0.1515		0.4487	
<i>Year</i>	0.5362	0.3591	0.1495	0.0765	-0.3618	-0.1615
	0.4632		0.8639		0.7357	
<i>% RPT Variable Non-Zero</i>	67.0%		51.2%		44.7%	

Table 13

Ordinary Least Squared Regressions of Industry-adjusted Returns on the Log of the Total Amount of Related Party Transactions in Total and by Executive and Non-Executive Board Members

Results of estimating equation 3 and equation 5. Coefficients are shown with White t-statistics below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Dependent Variable (<i>n=215</i>)	Independent Variables						Adj. R²
	Intercept	RPT*	Log(Sales)	EBITDA	R&D/Sales	Year	
Panel A: Industry-adjusted Returns Regressions							
<u>All Related Party Transactions</u>							
All RPTs	0.429 **	-0.061 ***	-0.019	1.011 ***	0.452 **	0.133 **	0.121
	2.236	-3.353	-1.178	3.065	2.523	2.310	
<u>Executive Related Party Transactions</u>							
Total Exec	0.351 **	-0.094 ***	-0.012	0.963 ***	0.564 **	0.139 **	0.129
	1.911	-3.635	-0.772	2.947	2.495	2.424	
<u>Non-Executive Board Related Party Transactions</u>							
Total Non-Exec Board	0.323	0.001	-0.013	1.045 ***	0.400 *	0.099 *	0.060
	1.652	0.093	-0.796	2.994	1.853	1.645	
Panel B: Residual Regressions							
<u>All Related Party Transactions</u>							
All RPTs	0.451 **	-0.101 **	-0.021	0.979 ***	0.437 **	0.114 *	0.086
	2.277	-2.473	-1.256	2.891	2.352	1.919	
<u>Executive Related Party Transactions</u>							
Total Exec	0.403 **	-0.094 **	-0.022	1.021 ***	0.472 **	0.127 **	0.098
	2.124	-2.127	-1.310	2.940	2.260	2.146	
<u>Non-Executive Board Related Party Transactions</u>							
Total Non-Exec Board	0.381 **	-0.053	-0.019	1.004 ***	0.427 **	0.112 *	0.067
	1.928	-1.132	-1.099	2.927	2.030	1.859	

Table 14

Ordinary Least Squared Regressions of Industry-adjusted Returns on the Log of the Total Amount of Loans and Other Related Party Transactions, in Total and by Executive and Non-Executive Board Members

Results of estimating equation 3. Coefficients are shown with White t-statistics below. Related party transactions data for 112 companies for two years (fiscal years 2000 and 2001) are pooled. Industry-fixed effects are included but not reported in table. Tests do not show the presence of heteroskedasticity and results are not corrected for it. ***, **, * denote significance at the 0.01, 0.05 and 0.10 levels, respectively. See table 1 for variable definitions.

Dependent Variable (<i>n=215</i>)	Independent Variables						Adj. R²
	Intercept	RPT*	Log(Sales)	EBITDA	R&D/Sales	Year	
Panel A: Industry-adjusted Returns Regressions							
<u>All Related Party Transactions</u>							
Loans - to	0.427 **	-0.018 **	-0.023	1.125 ***	0.404 **	0.102 *	0.095
	2.250	-2.126	-1.387	3.331	2.007	1.738	
Other RPTs	0.402 *	-0.005	-0.022	1.104 ***	0.421 **	0.115 *	0.077
	1.908	-0.718	-1.281	3.238	2.071	1.914	
<u>Executive Related Party Transactions</u>							
Loans	0.418 **	-0.017 *	-0.023	1.140 ***	0.398 **	0.104 *	0.091
	2.194	-1.829	-1.355	3.357	1.975	1.767	
Other RPTs	0.367 *	-0.005	-0.022	1.121 ***	0.423 **	0.115 *	0.075
	1.874	-0.462	-1.236	3.272	1.967	1.938	
<u>Non-Executive Board Related Party Transactions</u>							
Loans	0.338 *	-0.044 *	-0.014	1.035 ***	0.403 *	0.081	0.071
	1.736	-1.817	-0.843	2.995	1.853	1.330	
Other RPTs	0.391 *	-0.005	-0.020	1.023 ***	0.433 **	0.108 *	0.063
	1.858	-0.639	-1.148	2.943	1.995	1.786	
Panel B: Residual Regressions							
<u>All Related Party Transactions</u>							
Loans	0.374 *	-0.090 *	-0.018	1.062 ***	0.386 **	0.119 **	0.089
	1.960	-1.941	-1.079	3.086	2.001	1.989	
Other RPTs	0.332 *	-0.009	-0.014	1.037 ***	0.401 *	0.099 *	0.060
	1.649	-0.183	-0.816	2.992	1.891	1.643	
<u>Executive Related Party Transactions</u>							
Loans	0.380 **	-0.093 *	-0.019	1.058 ***	0.381 **	0.118 **	0.089
	1.995	-1.890	-1.112	3.064	2.010	1.979	
Other RPTs	0.343 *	0.037	-0.015	1.081 ***	0.385 *	0.090	0.065
	1.758	0.763	-0.910	3.097	1.719	1.525	
<u>Non-Executive Board Related Party Transactions</u>							
Loans	0.325 *	-0.148 **	-0.013	1.064 ***	0.385 *	0.082	0.071
	1.662	-2.223	-0.767	3.076	1.801	1.341	
Other RPTs	0.394 *	-0.039	-0.020	1.010 ***	0.433 **	0.108 *	0.064
	1.895	-0.813	-1.150	2.913	2.000	1.786	

APPENDIX

Examples of Related Party Transaction Disclosures

Direct Relationship. The following biographical description discloses three family relationships between three non-executive directors and the Chairman/CEO. Names and relationships were recorded, and these three relationships were coded as follows: **Type:** Direct Service – Non-Executive; **Primary Related Party:** Executive Chairman; and **Secondary Related Party:** Non-Executive Director (Saul Schottenstein, Ari Deshe, and Jon P. Diamond are all non-executive directors).

Jay L. Schottenstein, age 47, has served as Chairman and Chief Executive Officer of the Company and its predecessors since March 1992 and prior to that time he served as a Vice President and Director of the Company's predecessors since 1980. He has also served since March 1992 as Chairman and Chief Executive Officer of SSC, a privately-held company with interests in retailing, real estate and manufacturing. He has also served as Chairman since March 1992 and as Chief Executive Officer from April 1991 through July 1997, of VCD, a company that operates a chain of off-price department stores and is 56.3% owned by SSC, with the remaining shares publicly-held and traded on the New York Stock Exchange. Mr. Schottenstein served as Vice Chairman of SSC since 1986 and as a director of SSC since 1982. He has also served as an officer and director of various other corporations owned or controlled by members of his family since 1976. Jay L. Schottenstein is the nephew of Saul Schottenstein and the brother-in-law of Ari Deshe and Jon P. Diamond.

Source: (American Eagle Outfitters Inc. DEF 14A, filed 5/2/2001.
www.sec.gov)

Purchases from Related Party. The following excerpt is an example of real estate services provided by related parties. The transaction was coded as four transactions since there are four family members on the board of this company. Each was coded as follows: **Type:** Services provided by the related party to the company; **Primary Related Party:** Executive director for one of the transactions, and Non-executive director for three of the transactions; and **Secondary Related Party:** Entity owned by executive director for one of the transactions, and Entity owned by non-executive director for the other three.

The Company leases its distribution center and headquarters offices from an affiliate, Linmar Realty Company, a partnership owned indirectly by the Schottenstein-Deshe-Diamond families. In September 1999, the distribution center facility was expanded to add 120,000 square feet. As a result, the Company entered into an amended operating lease, effective September 1, 1999, expiring on December 31, 2020. The new lease provides for annual rental payments of approximately \$2.0 million through 2000, \$2.4 million through 2005, \$2.6 million through 2015, and \$2.7 million through the end of the lease. Additionally, the Company is required to pay all real estate taxes, insurance, maintenance and certain other expenses. For Fiscal 2000, the Company recorded \$2,541,000 of rent expense under the lease.

Source: (American Eagle Outfitters Inc. DEF 14A, filed 5/2/2001.
www.sec.gov)

APPENDIX

Examples of Related Party Transaction Disclosures (*continued*)

Sales to Related Party. The following excerpt includes an example of a company selling a business to a Chairman/CEO and his wife for \$33.9 million amount, coded as a Sale to related party (*type*), with the Executive Chairman as the *primary related party*.

On September 30, 2000, the Board of Directors approved the sale of Universal International, Inc. and Odd's-N-End's, Inc. (collectively, "Universal") to Universal Deals, Inc. and Universal Odd's-N-End's, Inc., respectively. Both Universal Deals, Inc. and Universal Odd's-N-End's are owned 100% by David and Sherry Gold who are significant shareholders of 99 Cents Only Stores. Mr. Gold is also Chairman and Chief Executive Officer of 99 Cents Only Stores. The sales price for Universal was the Company's carrying value as of the close of business on September 30, 2000 which was \$33.9 million as determined by the parties and approved by the Board of Directors of the Company. The sale was effective as of the close of business on September 30, 2000. The Universal net assets at September 30, 2000 included \$29.2 million in inventory, net fixed assets of \$7.6 million and \$0.6 million of other assets. These assets were offset by \$3.5 million of accounts payable, accrued and other liabilities. In connection with this transaction, 99 Cents Only Stores continues to provide certain ongoing administrative and other services to Universal pursuant to a Services Agreement.

Source: (99 Cents Only Store DEF 14A, files 4/11/2001.
www.sec.gov)

Loans to Related Party. The following excerpt summarizes loans to executives. Each is coded as a loan for stock purchase (*type*). The *primary related parties*, whose identities are disclosed in other portions of the disclosure, include one former CEO, one non-executive director, and two executives who are not board members.

In connection with the option exercises described under "Employment Arrangements, Termination of Employment Arrangements and Change of Control Arrangements," the following officers and directors delivered five-year full recourse promissory notes, bearing interest at an annual rate of 5.7%, except in the case of Mr. Frick whose note bears interest at an annual rate of 6.0%, in amounts and with the balances indicated:

<u>Officer or Director</u>	<u>Original Amount of Promissory Note</u>	<u>Amount Outstanding at December 31, 2000</u>
Michael J. McCloskey(1)	\$630,000	\$686,500
Robert W. Frick	299,997	323,489
William R. Phelps(2)	79,000	17,155
Ian P. Cavanagh	900,000	974,772

(1) \$304,500 remained outstanding as of March 8, 2001.

(2) This loan had been paid in full as of March 8, 2001.

(Source: Kana Communications Inc 10-K filed 4/2/2001.
www.sec.gov)