

Negative entrenchment effect of business group conglomerates on selling and purchasing related party transactions

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ABSTRACT

This study aims to explain the negative entrenchment effect arisen from selling and purchasing related party transactions on business group conglomerates. This study used 322 firm-year data of firms listed on Indonesia Stock Exchange in 2012-2013 period. This research provides evidence that the ownership by business conglomerates strengthened the negative entrenchment effect in both total of selling-purchasing related party transactions and selling-purchasing related party transactions which come from operating activities. Thus, from the result, it can be presumed that there might be a possibility of agency conflict arisen from selling-purchasing related party transactions when a firm is part of business conglomerates.

ABSTRAK

Penelitian ini bertujuan untuk menjelaskan pengaruh kubu negatif (negative entrenchment) muncul dari penjualan dan pembelian transaksi dengan pihak terkait di konglomerat kelompok usaha. Penelitian ini menggunakan 322 perusahaan data-tahun perusahaan yang terdaftar di Bursa Efek Indonesia pada periode 2012-2013. Penelitian membuktikan bahwa kepemilikan oleh konglomerat bisnis memperkuat efek kubu negatif pada baik total transaksi penjualan-pembelian pihak terkait maupun transaksi jual-beli pihak terkait yang berasal dari aktivitas operasional. Dengan demikian, dari hasil tersebut, dapat diduga bahwa mungkin ada konflik keagenan yang terjadi dari transaksi dengan pihak yang menjual-beli ketika suatu perusahaan merupakan bagian dari konglomerat bisnis.

1. INTRODUCTION

The main objective of a firm's financial reports is to provide useful information for stakeholders, both internal and external parties, in the economic decision-making process (IAS 1 Revised 2009). Therefore, the financial statements must meet the three main requirements such as being relevant, reliable, and comparable (Wild 2013). However, agency conflict could affect the quality of the financial statements. At the beginning of establishment of a firm, owners are also the executors of the operating activities. Along with growth of the firm, owners can no longer carry out operational activities due to the resource constraints. To overcome this problem, the owners finally give authority to the manager who has human capital. This is called agency theory, a contract of delegating the owner's tasks and authority to the manager as an agent in the

operational decision-making process (Jensen and Meckling 1976).

Agency conflict is not limited to information asymmetry between the owner and the management. In developing countries, most of the firms are generally owned by families or business groups. This structural difference is caused by weak law-enforcement in Asia, Eastern Europe, and Latin America (Shleifer and Vishny 1997; La Porta et al. 1999; Peng, Wei, and Yang 2011). In countries with high law-enforcement, control rights or voting rights of small investors can still be protected (Shleifer and Vishny 1997; La Porta et al. 1999). On the other hand, the majority of small investors in developing countries have virtually no control rights (Shleifer and Vishny 1997). As a result, small investors in developing countries will tend to form groups or concentrated in few major shareholders

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to overcome the problem of the lack of control rights (Shleifer and Vishny 1997). A concentrated ownership under a group which later evolved into pyramid ownership structure and cross-shareholding (Claessens et al. 2000) causing the controlling shareholder can set the course of the decision-making process or even any transaction activities within its subsidiaries even though the ownership is indirect (Bertrand et al. 2002). It is later known that the agency conflict in a concentrated ownership is mainly caused by differences between the interests of the controlling shareholders and the non-controlling shareholders (Villalonga and Amit 2006).

In firms with a concentrated ownership structure, Claessens et al. (2002) found that there is a wedge between the firm's cash-flow rights and control rights. Difference in a firm's cash-flow rights and the control rights could trigger negative entrenchment effect through the act of expropriating rights of non-controlling shareholders by controlling shareholders (Morck et al. 1988). The possibility of expropriation is getting the higher as the rights of the cash-flow is lower than the right of control (Johnson et al. 2000; Claessens et al. 2002; Joh 2003; Baek et al. 2004; Kang et al. 2014).

The difference between cash-flow rights and control rights also provides incentives for management to carry out tunneling, which is a process of transferring assets from a firm which has a less cash-flow to another subsidiaries or affiliates that have greater cash-flow rights (Bertrand et al. 2002; Cheung et al. 2006; Munir et al. 2013). There are several ways for firms to do the tunneling, it could be selling or purchasing the output beyond the market price, assets leasing, as well as the provision of collateral for the loan made by its subsidiaries (Bertrand et al. 2002). Tunneling would be easier if it is done between firms within the group. This is then referred as related party transactions.

This study focuses on the firms owned by business conglomerates in Indonesia where transactions related with sales and purchases are frequently done due to diversification in their business unit. If the nature of the related party transactions matches with the efficient transaction theory, then the firm will be able to increase the shareholder value because of the reduction in transaction costs (Stein 1997; Shin and Park 1999; Kang et al. 2014).

This research is derived from Kang et al. (2014) which is conducted in Republic of Korea where most of the firms are held by quite a few of conglomerates notably known as chaebol. The similar form also takes place in Indonesia since the majori-

ty of Indonesian firms is also controlled by several families and is owned by business conglomerates. Hence, this study is important as it would see whether the related party transactions carried out between firms in an Indonesian business group conglomerates are classified as an efficient transaction or tend to have an opportunistic nature.

This study investigates and provides empirical evidence on the effect of the difference in control rights and cash-flow rights toward related party transactions and the effect of the business conglomeration in the direction of differences in control rights and cash-flow rights on related party transactions.

2. THEORETICAL FRAMEWORK AND HYPOTHESES

Negative Entrenchment Effect

Jensen and Meckling (1976) define agency theory as a contract between the owner (principal) and the manager (agent) whose job is to manage the resources owned by the owner, operate the business activities, and take strategic decisions as the firm's development efforts. The contract of delegating these tasks occurs due to limited resources owned by the owner. It is because along with the growth of the firm, the owners increasingly difficult to control the entire operating activities and, as a solution, the owners choose to hire others who have the resources (human capital) as the manager to run the firm (Shleifer and Vishny 1997).

However, the transfer of authority has led to information asymmetry. This is due to the owners rarely directly involved in operational activities and assumed the manager will take operational and strategic decisions, which are expected to improve the performance of the firm and in line with the objectives of the owner. On the other hand, both the owner and manager, is a man who always think rationally so that each party would seek to maximize personal gain (Jensen and Meckling 1976). The incomplete contracts and the professional expertise possessed by agent (Shleifer and Vishny 1997) makes the manager has the opportunity to mistreat the authority owned. As a result, the owner must disburse some of their funds to supervise the manager so that decisions taken by manager are aligned with the objectives of the owner

The weakness of the agency theory proposed by Jensen and Meckling is, the research was carried out in the country with a dispersed ownership structure, which is considered not representative to explain conflicts that arise in other countries. Shleifer and Vishny (1997) argue that corporate gover-

nance and protection of shareholders are two important factors, which affect the agency conflict.

In countries with a decent governance and high legal protection, dispersed ownership is not a problem because the control rights of the owners can still be offset by good governance mechanisms and enforcement (Shleifer and Vishny 1997). This condition is different from the majority of countries in the world that still have a low-level governance practice and weak legal protection such as in Asia and Latin America (Shleifer and Vishny 1997; La Porta et al. 1999; Peng, Wei, and Yang 2011). In those countries, dispersed ownership becomes a new problem for investors with a small portion of share ownership who are not well informed and their control rights has become meaningless to conduct any surveillance activities over the manager (Shleifer and Vishny 1997).

As the ownership structure is concentrated, the extent of control over a firm is shown by the control rights held by the controlling shareholder (Fan and Wong 1992; Claessens et al. 1999; La Porta et al. 1999; Francis, Schipper, and Vincent 2005). A concentrated ownership under a group, which later evolved into pyramid structures and cross-shareholding, (Claessens et al. 2000) causing the controlling shareholder could set the course of the decision-making process or transactions with subsidiaries or affiliates even though the ownership is indirect (Bertrand et al. 2002). Thus, in countries with concentrated ownership, the agency conflict is no longer between the owner and the manager; but between the controlling shareholders with non-controlling shareholders (Shleifer and Vishny 1997; La Porta et al. 1999).

The control rights are important since the controlling shareholders can direct both of the strategic and operational decisions in accordance with their own goals; electing the managing director and finance director (Francis, Schipper, and Vincent 2005), for instance. With the ability to put people in those positions, the controlling shareholder can now easily direct the operational activities so that all of the strategic policies taken will benefit their party.

The magnitude of an authority so that the controlling shareholder is able to direct the course of the firm's activities is called entrenchment effect (Claessens et al. 2002). The entrenchment effect can be positive if the control rights of the controlling shareholders are used to monitor the performance of management. However, the entrenchment effect can be negative if the controlling shareholders use it for the opportunistic purpose such as pointing

family members in strategic positions to facilitate the approval process for any decision that actually requires the approval of non-controlling shareholders through the General Meeting of Shareholders (Francis, Schipper, and Vincent 2005).

A significant difference between the cash-flow right and the control rights can lead to negative entrenchment effect through the act of expropriating non-controlling shareholders' rights by the controlling shareholders (Morck et al. 1988; Johnson et al. 2000; Claessens et al. 2002; Joh 2003; Baek et al. 2004; Kang et al. 2014). Therefore, once the control rights are higher than the cash-flow rights, then the firm has been run by the controlling shareholders, not the managers (La Porta et al. 1999). An excessive degree of control rights in the pyramid structure gives impact on the various aspects. It is found that a high magnitude in the control rights of the controlling shareholder will reduce the level of information in financial reports (Fan and Wong 2002; Francis, Schipper, and Vincent 2005), reduce accountability (Grossman and Hart 1988 in Francis, Schipper, and Vincent 2005), and provide incentives for management to carry out tunneling (Mork, Wolfenzon, and Yeung 2005).

Related Party Transactions

The activity of shifting resources between firms in the same group is known as a related party transaction (Riyanto and Toolsema 2008). In Indonesia, the definition of related party transactions is referred to PSAK 7 (Revised 2010): Related Party Disclosures adopted from IAS 24: Related Party Disclosures. Based on PSAK 7 (Revised 2010) paragraph 9, related party transaction is defined as a transfer of resources, services or obligations between reporting entities with related parties, regardless of whether a price is charged.

Related transactions are frequently be carried out by firms in the world, particularly if a group has a diversified business (OECD 2009; Kang et al. 2014). With the existence of related party transactions, the operations will be more efficient because it can reduce the transaction costs (Chang and Hong 2000). Related party transactions which are efficient and meet the economic needs of the firm is known as efficient transaction hypothesis (Chang and Hong 2000; Khanna and Palepu 2000). This theory turn into the basis that the transaction would provide benefits related for the firm.

Chien and Hsu (2010) found out that there is a positive correlation between firm earnings and selling activities with related parties. Moreover, the negative impact arising from industry earnings

shock can be reduced with sales transactions with related parties (Chien and Hsu 2010). In Indonesia, a related party transaction associated with liability is proven to increase the value of the firm (Utama and Utama 2013 in Al Aggugi 2014). The positive effect of related party transactions in Indonesia to the value of the firm is also confirmed by Singeten-ta (2012).

However, there is an inconsistency in the efficient transaction hypothesis. Related party transactions that are commonly found in Asia could potentially be used as one of the ways to expropriate the rights of non-controlling shareholders (Johnson et al. 2000). Related party transactions are closely related to business diversification (OECD 2009; Kali and Sarkar 2011; Kang et al. 2014) and pyramid-ownership structure (Shleifer and Vishny 1997; Morck et al. 2005; Riyanto and Toolsema 2008; Peng, Wei, and Yang 2011; Kang et al. 2014). Hence, related party transactions are often challenged through legal channels (Riyanto and Toolsema 2008) as the pyramid-ownership structure is rarely found in countries with good governance and high shareholder protection. Therefore, come out the second theory which states more related transactions are abusive (Chen, Wang, and Li 2012) because of the high chance of expropriation of the non-controlling shareholders' rights (Morck et al. 2005; Djankov et al. 2008; Peng, Wei, and Yang 2011), which known as conflict of interest hypothesis (Chien and Hsu 2010; Kohlbeck and Mayhew 2010).

Hypotheses Development

Various studies have confirmed the effect of the negative entrenchment effect on related party transactions (Morck, Wolfenzon, and Yeung 2005; Riyanto and Toolsema 2008; Chen, Wang, and Li 2012). The abusive related party transactions which lead to the expropriation rights of the non-controlling shareholders are commonly found in a firm where there is a high control-ownership wedge, which is a proxy of negative entrenchment effect (Peng, Wei, and Yang 2011). Therefore, it can be concluded that related party transactions in a firm which has a pyramid-ownership structure indicated with control rights in excess of its cash-flows rights have a tendency to be abusive and in line with the conflict of interest hypothesis (Fan and Wong 2002; Morck, Wolfenzon, and Yeung 2005; Peng, Wei, and Yang 2011). Thus the first hypothesis is:

Hypothesis 1: Negative entrenchment effect gives positive effect on related party transactions.

Through the pyramid ownership structure,

business conglomerates have an incentive to diversify its business (OECD 2009). Through the business diversification, those groups can do a lot of related party transactions (Kim and Yi 2006; Riyanto and Toolsema 2008; Kali and Sarkar 2011). A firm is considered will get benefits from diversified business units as it can overcome limitations arising from capital markets, product markets, as well as the labor market (Khanna and Palepu 2000 in Lins and Servaes 2002). In addition, with business diversification, a firm can also reduce transaction costs (Stein 1997; Shin and Park 1999; Kang et al. 2014).

However, both horizontal and vertical business diversification have not given any evidence that it can increase the value of the members of conglomerate groups (Kim and Yi 2006). Hence, there is a presumption that related party transactions are aimed to tunnel a firm's assets (Kang et al. 2014); not for the purpose of efficiency which can increase the value of the firm. Therefore, it can be concluded that a firm owned by conglomerate groups has a high proximity to negative entrenchment effect as a result of the pyramid ownership structure that encourages diversification and lead to higher volume of related party transactions. Thus the second hypothesis is:

Hypothesis 1a: Ownership by conglomerate groups strengthens the effect of negative entrenchment effect of related party transactions.

A conglomerate group can diversify its business either related or unrelated with the main activity of the parent firm (Kang et al. 2014). Assuming the diversification aims to reduce transaction costs (Stein 1997; Shin and Park 1999), most of the related party transactions occurred are linked with operational activities of its main business. However, this assumption is not entirely acceptable since various studies suggest diversification does not increase the value of the firm (Lins and Servaes 1999; Kali and Sarkar 2011). Thus, there is a possibility that a member firm of conglomerate groups use operating related-party transaction to tunnel its assets. This can occur because the operating related-party transactions are subtle and take place throughout the accounting period (Kang et al. 2014). Hence, the next hypothesis is:

Hypothesis 1b: Ownership by conglomerate groups strengthens the negative entrenchment effect of the operating related-party transactions.

3. RESEARCH METHOD

Population and Sample

Using purposive sampling method, the total sample of 322 firm-years is as shown in Table 1.

Table 1
Sample Selection

Population: Firms listed at Indonesia Stock Exchange as of 2013	484
-/- Firms listed at Indonesia Stock Exchange after 2012	(31)
-/- Financial institutions	(79)
-/- Firms with negative equity	(8)
-/- Firms with incomplete annual report	(18)
-/- Firms with reporting currency other than Indonesian Rupiah	(64)
-/- Firms which do not disclose selling-purchasing related party transactions	(112)
-/- Firms without a complete ownership structure	(11)
Total of firm	161
Number of observation	x ²
Final Sample	322

Research Model

Model 1: Is used to test hypothesis 1 which is the effect of negative entrenchment effect on the total value of selling and purchasing related party transactions.

$$RPT_i = \beta_0 + \beta_1 DVC_i + \beta_2 SIZE_i + \beta_3 LEV_i + \beta_4 ROA_i + \beta_5 AVOID_i + \beta_6 MB_i + \beta_7 CGI_i + \sum Year_i + \varepsilon_i \quad (1)$$

Model 2: Is used to test hypotheses 2a and 2b: the effect of an ownership by conglomerate group on the entrenchment negative entrenchment effect and the value of operating related-party transactions.

$$RPT_i \text{ or } RPT_O_i = \beta_0 + \beta_1 DVC_i + \beta_2 GROUP_i + \beta_3 DVC \times GROUP_i + \beta_4 SIZE_i + \beta_5 LEV_i + \beta_6 ROA_i + \beta_7 AVOID_i + \beta_8 MB_i + \beta_9 CGI_i + \sum Year_i + \varepsilon_i \quad (2)$$

Description of variables:

RPT Total value of related party transactions (selling and purchasing RPT)/market value of equity;

RPT_O Total value of selling and purchasing operating RPT/market value of equity;

DVC Control-ownership wedge ratio of the controlling shareholder (1+control rights)/(1+cash-flow rights);

GROUP 1 if a firm is owned by conglomerate groups, 0 if not;

SIZE Natural logarithm of net sales (in million Rupiah);

LEV Total debt/total equity;

ROA Net income/total asset;

AVOID 1 if 0 < ROA < 2%, and 0 if not;

MB Market value of equity/book value of equity;

CGI Corporate Governance Index (proxied by the role of board of commissioner and audit committee);

Year Year indicator.

Operational Variable

Dependent Variable:

The calculation of related party transactions to test hypotheses 1 and 1a using the done in the follow-

ing formula:

$$RPT_i = \frac{\text{Total Value of RPT}_i}{\text{Market Value of Equity}_i} \quad (3)$$

Description:

RPT = related party transactions

Total Value of RPT includes operating and non-operating RPT.

Operating related-party transactions is used to test hypotheses 1b which is obtained from the following formula:

$$RPT_O_i = \frac{\text{Operating RPT}_i}{\text{Market Value of Equity}_i} \quad (4)$$

Description:

Operating RPT is selling and purchasing of operating RPT.

Measurement of the Negative Entrenchment Effect

Using the ratio of control-ownership wedge (DVC) as a proxy of negative entrenchment effect, DVC is calculated from the difference between the control rights and cash-flow rights owned by the controlling shareholder. The control rights are calculated by looking at the smallest control rights (weakest link) owned by any individual shareholders in each chain of ownership structure. Individual shareholders are then traced his identity to determine whether there is a family relationship with the other shareholders. This search will lead to information about certain family who is the ultimate owner of a group. If there is a family relationship with the other shareholders, the control rights of the members will be added collectively and compared back to the weakest link the chain of ownership structure. While the cash-flow rights are calculated by multiplying the cash-flow rights of the controlling shareholder in the ownership structure along the chain of ownership.

$$Wedge (DVC)_i = (1 + control\ rights_i) \div (1 + cash\ flow\ rights_i) \quad (5)$$

Table 2
Descriptive Statistics of the Entire Observations

Variable	Mean	Std. Dev.	Min	Max
RPT	0.401	1.100	0.000	14.109
RPT_O	0.304	0.600	0.000	3.650
DVC	1.051	0.088	1.000	1.343
SIZE	7,422,882	18,800,000	9,023	194,000,000
LEV	28.669	22.863	0.000	101.910
ROA	0.104	0.154	-0.610	0.850
AVOID	0.152	0.360	0.000	1.000
MB	2.946	3.333	-15.470	19.730
CGI	58.025	8.047	22.000	80,000

Table Description

RPT = Total value of related party transactions (selling and purchasing RPT)/market value of equity. RPT_O = Total value of operating selling and purchasing RPT/market value of equity. DVC = Control-ownership wedge ratio of the controlling shareholder (1+control rights)/(1+cash flow rights). SIZE = Natural logarithm of net sales (in million Rupiah). LEV = Total debt/total equity. ROA = Net income/total asset. AVOID = 1 if $0 < ROA < 2\%$, and 0 if not. MB = Market value of equity/book value of equity. CGI = Corporate governance index (proxied by the role of Board of Commissioner and audit committee).

4. DATA ANALYSIS AND DISCUSSION

Descriptive Statistics

Of the 322 observations, as in Table 2, it can be seen that the variables of related party transactions (RPT) and operating related party transactions (RPT_O) have a high deviation standard. This is due to the nature of the transaction which is different for each company in the current year. The mean value of related party transactions (RPT) is 40% of the market value with a minimum value of 0, which means there are no transactions in 2012 (3 firms) or 2013 (7 firms). The highest value of 1410.9% in RPT is derived from related party transactions undertaken by PT Wilmar Cahaya Indonesia (CEKA).

On average, the operating related party transactions in Indonesian firms are amounting 30.4% of the market value. The highest selling and purchasing activities with related parties are found in 2013 which is done by PT Eterindo Wahanatama with the value of 365% of its market value.

The DVC variable shows the control-ownership wedge in the form of a ratio. The mean of the wedge is 5.1% with a minimum value of 1, which means a firm is fully owned by a family, government, or other institutions; therefore, there is no separation of control rights and cash-flow rights. The highest wedge ratio is 34.3%, which may lead to evidence that the ownership structure in Indonesia is still in a form of pyramid structure which is characterized by the separation of control rights and cash-flow rights (Claessens 2000).

However, there are limitations for the variable DVC. Of the 322 observations, 185 observations or 57.45% of the sample has a wedge of 0. This is due to some firms are owned by foreign firms so that the ownership structure cannot be searched further.

Only two foreign firms in which its ownership can be traced; i.e. CAB Holding, which is controlled by Salim Group and Asia Pacific Holdings Limited owned by Lippo Group. Another finding is, the Indonesian controlling shareholders in conglomerate groups are generally became the second-largest shareholder after the foreign controlling shareholder (MNCN, KPIG in 2012) or the government (JRPT, PJAA). It certainly causes bias in the calculation of the control-ownership wedge and the status of the company as part of business group conglomerates.

The firm size (SIZE) also varies with average sales of Rp 7 trillion. Using net sales as a proxy, Astra through ASII topped the observations with net sales in 2013 amounting up to Rp 194 trillion, followed by TLKM and HMSP.

The funding of Indonesian firms is in majority still obtained from loans with average in the leverage of 28%. The high level of debt may increase agency conflict as there are opportunities for controlling shareholders to manipulate earnings through related party transactions (Kang et al. 2014).

The return on net sales to assets is shown through ROA in which the average ROA of Indonesian firms has a rate of return of 10.4%. However, the deviation standard of the ROA is quite high. In 2012 and 2013, 20 firms had a net loss which affects the ROA that is worth minus.

In line with the ROA, firms with poor performance tend to do an opportunistic earnings management (Kang et al. 2014). In 2012 and 2013, 49 firms have the opportunities to conduct earnings management when $0 < ROA < 2\%$ as indicated by the variable AVOID. The mean of AVOID is quite low at 0.152, which means the majority of firms in Indonesia still have a good performance.

Table 3
Descriptive Statistics of Group and Non-Conglomerate Group

Variable	Group (n = 150)		Non-Group (n = 172)	
	Mean	Std. Dev.	Mean	Std. Dev.
RPT	0.331	0.789	0.463	1.313
RPT_O	0.264	0.572	0.338	0.624
DVC	1.101	0.105	1.007	0.030
SIZE	8,955,020	24,000,000	6,086,715	12,500,000
LEV	30.717	22.47	26.883	23.118
ROA	0.091	0.131	0.114	0.171
AVOID	0.133	0.341	0.169	0.375
MB	2.558	2.786	3.285	3.722
CGI	57.687	6.985	58.320	8.880

Table 4
The Test Result of Hypothesis 1

Variable	Predicted Sign	Coefficient	Probability	Note
Intercept	+/-	1,461	0.000	
DVC	+	-0.875	0.000	***
SIZE	+	-0.017	0.108	
LEV	+	-0.004	0.000	***
ROA	-	0.251	0.062	*
AVOID	+	-0.104	0.082	*
MB	+/-	-0.032	0.000	***
CGI	-	-0.001	0.312	
Year	+/-	-0.004	0.461	
R-Squared		0.162		
Prob > F		0.000		

***Significant at the 1% level, **Significant at the 5% level, *Significant at the 10% level.

The market-to-book value ratio (MB) in Indonesian firms is still relatively small; it is 2.946% in average. The highest book value is held by HMSF in 2012 (19.73%) while the lowest is ARGO (-15.47%). Firms with either high or low market-to-book-value have the same opportunities to do expropriation activities through related party transactions (Kang et al. 2014).

Using a total of 84 questions in *checklist* of Hermawan (2009), the average Indonesian firms scored 58.02 (69.07%) or 2 points above the minimum value for the index of corporate governance. The result above indicates that corporate governance practice related with the role of Board of Commissioner and audit committee is quite good but still needs much improvement.

Descriptive Statistics of Group and Non-Conglomerate Group

The total sample of 322 observations is divided into two groups: firms that belong to the conglomerate group and non-conglomerate group. After the identification of the owner, it is found out that 150 observations (46.58%) are owned by the conglomerate

group while 172 (53%) observations are a non-conglomerate group. The result shows the average of related party transactions (RPT) in non-conglomerate group is higher than in the conglomerate group.

The operating related party transactions (RPT_O) in the conglomerate group have a mean of 26.4% of the market value. This number is lower compared to the related party transactions in non-conglomerate group, which is in the range of 33% of the market value (see Table 3). This outcome shows related party transactions under a non-conglomerate group has a higher market value on its equity. It can be interpreted that more investors consider related party transactions done by a non-conglomerate firm is more likely to be efficient and investors are responding positively for such transactions.

The control-ownership wedge (DVC) of the conglomerate group is higher than the non-conglomerate group. These results are in line with Claessens et al. (2000) which states countries in Asia are generally concentrated in its ownership structure which is characterized by a high separa-

Table 5
Test Results of Hypothesis 1a

Variable	Predicted Sign	Coefficient	Probability	Note
Intercept	+/-	1.733	0.000	
DVC	+	-1.155	0.000	***
GROUP	+	0.021	0.319	
DVCXGROUP	+	0.629	0.066	*
SIZE	+	-0.016	0.120	
LEV	+	0.004	0.000	***
ROA	-	0.245	0.067	*
AVOID	+	-0.101	0.089	*
MB	+/-	-0.032	0.000	***
CGI	-	-0.002	0.312	
Year	+/-	-0.003	0.467	
R-Squared	0.163			
Prob > F	0.000			

***Significant at the 1% level, **Significant at the 5% level, *Significant at the 10% level.

Table 6
Test Result of Hypothesis 1b

Variable	Predicted Sign	Coefficient	Probability	Note
Intercept	+/-	1.714	0.000	
DVC	+	-1.149	0.000	***
GROUP	+	0.020	0.324	
DVCXGROUP	+	0.630	0.064	*
SIZE	+	0.016	0.125	
LEV	+	0.004	0.000	***
ROA	-	0.244	0.069	*
AVOID	+	-0.104	0.084	*
MB	+/-	-0.031	0.000	***
CGI	-	-0.002	0.028	
Year	+/-	-0.003	0.470	
R-Squared	0.162			
Prob > F	0.000			

***Significant at the 1% level, **Significant at the 5% level, *Significant at the 10% level.

tion in the control rights and cash-flow rights. In a conglomerate group, the average ratio is 10% while the average non-conglomerate group has a ratio of 0.70%.

The funding sources of the firms owned by conglomerate groups are also mostly from loan with an average on the leverage of 30%. The ROA mean of the conglomerate group is 9%; it is lower than non-conglomerate group in which leverage is 11%. Firms affiliated with conglomerate groups are considered to have a higher chance of expropriation by the capital market. This can be seen in the average of market-to-book-value (MB) of 2.55. This value is lower than the average in a non-conglomerate group in which MB has a value of 3.28. The results above prove that capital market has done a discount to brace a chance of expropriation.

Looking at AVOID, non-conglomerate group has a higher likelihood to do expropriation activities with a mean value of 0.16. The corporate governance index for conglomerate group is lower than the non-group with a value of 57, 68. However, this difference is not significant where the non-conglomerate group has a mean value of 58.32.

Negative Entrenchment Effect on Selling and Purchasing Related Party Transactions

The negative effect is found among the negative entrenchment effect on related party transactions (Table 4) so that hypothesis 1 is rejected. From the result, it can be concluded that the act of expropriation over rights of the non-controlling shareholders is not made through selling and purchasing related party transactions. This result differs from Kang et al. (2014) who found a positive effect between nega-

tive entrenchment effect and selling-purchasing related party transactions.

There are two possible causes of the differences in the direction of this variable. First, the quality of disclosure of related party transactions in Indonesia is still low so that the value of selling and purchasing related party transactions in the financial statements has not revealed the actual transactions occurred. Secondly, the ultimate owner of some firms cannot be traced since they are owned by foreign firms, which act as the controlling shareholder; hence, the ownership structure is considered as direct ownership. Third, other than owned by foreign firms, some firms are directly owned by a family as found in Maspion Group. It has a distinct pyramid structure; yet, all of the shareholders in the structure are the family members so that the control and the cash-flow rights acquired remains 100%.

Negative Entrenchment Effect of the Conglomerate Group on Selling and Purchasing Related Party Transactions

A positive effect is found among the negative entrenchment effect of the conglomerate group on related party transactions. The coefficient of DVCXGROUP is worth 0.629 with 0.066 of significance (Table 5). From this result, it can be concluded that there is opportunity for the conglomerate group to expropriate the non-controlling shareholders' rights through selling and purchasing related party transactions. Therefore, the hypothesis 1a is accepted. This result is consistent and supports the conflict of interest hypothesis for related party transactions.

Riyanto and Toolsema (2008) reported the negative entrenchment effect provides incentives for controlling shareholders to engage in self-dealing activities by exploiting voting rights of the non-controlling shareholders. Related party transactions in the company with pyramid-ownership structure generally have two objectives; between tunneling or propping (Riyanto and Toolsema 2008; Peng, Wei, and Yang 2010). Tunneling is the activity of transferring resources from subsidiaries to parent company in the pyramid-ownership structure (Riyanto and Toolsema 2008) with a purpose to put the cash-flow rights back to the controlling shareholders (Bertrand, Mehta, and Mullainathan 2000). In contrast, propping is the transfer of resources from parent company to subsidiary that aims to prevent any financial insolvency in its subsidiary (Friedman, Johnson, and Mitton 2003). Thus, propping is commonly done when a subsidiary is having financial difficulty (Ying and Wang 2013).

Related party transactions that aim to tunnel the assets are clearly a form of expropriation over the rights of minority shareholders in a subsidiary (Riyanto and Toolsema 2008) so that it can be understood if related party transactions occurred in a firm with pyramid-ownership structure will be responded negatively by the markets as found by Peng, Wei, and Yang (2011). Once a firm is in a good financial condition, the controlling shareholder will tend to conduct related party transactions in the form of tunneling and, in return, market will give a negative response to the announcement of the transaction (Peng, Wei, and Yang 2011).

Although there are different opinions on the purpose of related party transactions, there are two conclusions that can be drawn: first, related party transactions in the form of tunneling are clearly an expropriation over the rights of the non-controlling shareholders in subsidiaries. Secondly, firms with a pyramid-ownership structure, in which is generally owned by the conglomerate groups and characterized by the separation of voting rights and cash-flow rights, trigger the negative entrenchment effect through abusive related party transactions using either tunneling or propping mechanisms.

Negative Entrenchment Effect of the Conglomerate Group on Operating Related Party Transactions

Negative entrenchment effect through related party transactions on operating activities is found as a firm is a member of a conglomerate group as shown by DVCXGROUP variable in the Table 6, so that the hypothesis 1b is accepted. One reason for choosing the operating related party transaction as a way of asset tunneling is, operating related party transactions is relatively easy to do since the transfer pricing activity, as well as the sale and purchase of production or raw materials, will take place throughout the accounting cycle because it relates to the operations of the company.

If the value of a non-operating RPT is insignificant, it can be certain that the conglomerate group would choose non-operating transactions as a way of tunneling because of the high degree of subjectivity (Kang et al. 2014). However, the non-operating RPT is normally high in value and material. It even could lead to potential conflict of interest (Sari, Djajadikerta, and Baridwan 2013) so as to invite the attention of regulators as well as non-controlling shareholders (Kang et al. 2014).

Analysis of the Control Variables

Other variables that give an effect on related party transactions are leverage, return on assets, AVOID,

and market-to-book-value. For the leverage (LEV), the increase of related party transactions is in line with the increase in the financial risk as most of the funds are obtained from debt. These results fit the initial prediction that firms with a high debt level tend to do an earning management through related party transactions.

The positive coefficient on return on assets (ROA) indicates firms with a good financial performance tend to have a high related party transaction. This result is consistent with Kang et al. (2014) and provides evidence that every firm, with either good or bad financial performance, has the opportunity to manage its earnings through related party transactions. Conversely, when a firm's ROA is below 2%, the related party transactions decrease as shown in the variable AVOID which has a negative direction.

There are differences between the predictions in the direction of the coefficient for variable AVOID. Such differences may be because of this research took the sample in 2012 and 2013 period where some firms were still under pressure from the global economic crisis that hit Europe in 2010. The impact is, the export-based company has a low return on assets as they have transactions with external parties, especially when the customers residing abroad. It is strongly related with the AVOID variable. In this case, then, related party transactions are in line with efficient transaction hypothesis as found by Chien and Hsu (2010) stating that related party transactions can reduce the financial risk arising from the industry earnings shock.

The variable of market-to-book-value (MB) proves a negative effect on both of total and operating related party transactions. This finding is in contrast to Skinner and Sloan (2002) where a firm with a high market-to-book-value tends to conduct abusive related party transactions to prevent a decline in the stock price. The negative effect between market-to-book-value in this research is consistent with the findings of Kang et al. (2014) stating when a firm has a high chance to grow, then the gain from transactions with third parties are much higher. From this result it can be concluded that firm actually considers related party transactions cannot be classified as an efficient transaction.

5. CONCLUSION, IMPLICATION, SUGGESTION, AND LIMITATIONS

A concentrated ownership structure makes the agency conflict in Indonesia, taking place between the controlling shareholders and non-controlling shareholders. When the controlling shareholders

have a significant control rights, they can direct the firms run the policies. This is called entrenchment effect. The entrenchment effect can be positive when the control rights can improve the oversight function over the management that can increase the company's value. On the other hand, there is a chance of expropriation activities if the control rights are higher than the cash-flow rights. In this case, the entrenchment effect will turn its direction to be negative.

This research looks at the effect of negative entrenchment on selling-purchasing related party transactions. The result is, negative entrenchment effect negatively affects selling and purchasing related party transactions so that it can be concluded that the expropriation of the rights of non-controlling shareholders are not made through selling and purchasing related party transactions.

However, this study proves that the ownership by conglomerate groups strengthens the negative entrenchment effect both on the total of related party transactions and operating related-party transactions. Once a firm is owned by a conglomerate groups, there is a possibility of tunneling through selling and purchasing related party transactions as a result of the diversification efforts undertaken by the group. This result supports previous studies which prove the related party transactions in countries with a concentrated ownership under the control of conglomerate group tend to be abusive and potentially lead to the expropriation of rights of the non-controlling shareholders.

The limitations and suggestions for further research development are that the related party transactions on sales and purchases only use the information contained in the financial statements on Notes to the Financial Statements section and it does not take account of any transaction with conflict of interest in a publication issued by the Indonesia Stock Exchange as conducted by Sari, Djajadikerta, and Baridwan (2014). For further research, transactions with conflict of interest can be put in to the related party transaction formula as a component of non-operating activities.

Besides that, the limitation of this research include that the value of related party transactions is the total of related party transactions and does not separated into both selling and purchasing transactions. Future studies can perform regression for each category of selling and purchasing related party transactions. This grouping helps to explain the variable AVOID and MB. Firms with a low return on assets and a high market-to-book ratio tend to do sales transactions with external parties compared to purchases transaction since the sales will

provide higher incentive for the firm.

In relation to the party transaction disclosure requirements, as enclosed in PSAK No. 7 (Revised 2010) and Bapepam-LK No. VIII. G. 7 of 2000, the regulators can reduce the risk of expropriation the rights of non-controlling shareholders from the abusive related party transactions. However, in practice, the quality of disclosure of related party transactions in Indonesia is still low since not all of the points in the regulation are disclosed by the management. Therefore, it is necessary for the regulators to ensure that all elements related with disclosure on related party transactions should be comprehensively described in the financial reports.

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