

**Does concentrated founder ownership affect Related Party Transactions? Evidence  
from Emerging Economy**

Shashank Bansal  
Research scholar, Department of Management Studies,  
Indian Institute of Technology Madras, Adyar, Chennai, India-60036  
Email id: bansal.shashank1210@gmail.com.

M. Thenmozhi\*  
Professor, Department of Management Studies,  
Indian Institute of Technology Madras, Adyar, Chennai, India-60036  
Email id: mtm@iitm.ac.in

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\*Corresponding Author

**For Discussant**

EFM classification codes: 150

# **Does concentrated founder ownership affect Related Party Transactions? Evidence from Emerging Economy**

## **Abstract**

Related Party Transactions (RPTs) is a topic of increasing interest around the world and can have a large impact on financial performance of the firm. Relatively small literature in the field motivates us to examine whether concentrated founder ownership affects the degree of RPTs in a firm. We further examine what type of RPTs are affected by concentrated founder ownership and also analyse if related transactions influence the firm value. Using the data set of all NSE listed firms from 2002 to 2015, we find that concentrated founder ownership in India is positively associated with the magnitude of RPTs. We empirically find that concentrated founder ownership encourages RPTs which are beneficial for the minority shareholders, compared to RPTs which are more likely to expropriate minority shareholders. We also document that business group firms encourage RPTs more compared to standalone and state-owned firms. Finally, we find that RPTs in Indian firms on an average are associated with higher firm value and this value increment is observed more when concentrated founder ownership is high. Overall, we find that in the Indian market, reputation incentive plays a very important role for concentrated founder ownership and they align their interest with minority shareholders by encouraging RPTs which are beneficial for them. We support the view of efficient transaction hypothesis and find that RPTs can be used as an efficient mechanism in under-developed capital markets, thus increasing the firm value.

**EFM classification codes:** 150, 620

**Keywords:** Related Party Transactions, Ownership Structure, Emerging Markets, Corporate Governance

## **1 Introduction**

Unlike developed economies, emerging economies like India are predominantly controlled by controlling shareholding (concentrated founder ownership). In India, average concentrated founder ownership is 53.02% which is not the case in widely held firms in developed economies. The presence of concentrated controlling shareholders in firms protect them from outside disciplining forces resulting in expropriation of minority shareholders (Cronqvist and Nilsson 2003; Claessens, et al., 2002; Bebchuk, et al., 2000). Lack of strong legal environment may exacerbate the expropriation of minority shareholders through self-dealing related party transactions (RPTs) and transferring of resources among the firms to increase their personal benefit. However, in India, were largely founder controls the firm through direct ownership and presence of business groups and family firms makes firm's value of these firms directly associated with the reputation of the promoting family (Smith and Amoako-Adu 1999; Wiwattanakantang 2001) and if concentrated founder owners get private benefit through self-dealing RPTs, outside investors will penalise the founder with share price discount and the founders will end up holding a large proportion of shares at a discounted price (Wiwattanakantang 2001). Considering this unique and interesting setting, it becomes crucial to address the following questions: Does concentrated founder ownership affect the RPTs? Which type of RPTs are affected by concentrated founder ownership? Does RPTs have any influence on the value of the firm?

RPTs are defined as transactions between a firm and its subsidiary company, key personnel and their relatives. RPTs are substantial in both western and Asian economies. However, RPTs are legitimate and common business practice around the globe but they can have both abusive and value enhancing effect on firm value. RPTs can help firm and its affiliates in reducing the transaction cost and can be used as efficient mechanism for under developed capital markets (Gordon et al. 2007; Shin and Park, 1999; Stein, 1997; Khanna and Palepu, 1997). However, RPTs are also viewed as value destruction activities, since RPTs may be used as a tool for tunnelling and earnings management (Johnson et al. 2000; Jian and Wong 2004; Claessens et al. 2006). Given that RPTs can take on many different shades, a firm should target at discouraging the harmful RPTs and encourage the beneficial ones. Striking this balance is not easy task and is something that attracts the interest of policy makers and academicians. In line with this, in this study, we analyse how controlling shareholders strike out the balance and how it affect the firm value.

Using 12,245 firm year observations from year 2002 to 2015, we perform an indepth analysis using fixed effect panel regression framework. In our first analysis, we focus on concentrated founder ownership impact on RPTs and hypothesize that concentrated founder ownership increases the likelihood of RPTs. We find that concentrated founder ownership have a significant positive influence on RPTs decisions of Indian firms. We also find that that concentrated founder ownership encourage more operating RPTs in firms' opposed to non-operating RPTs which are considered more suitable for tunnelling activity (Bertrand et al., 2002).

In the expanded analysis, we categorize RPTs by its type and counterparty and group them into two separate categories, as RPTs likely to benefit the minority shareholders and RPTs likely to expropriate the minority shareholders. Beneficial RPTs include cash and loan receipts from connected parties and subsidiary trading relationships and expropriative RPTs include asset acquisitions, asset sales, and cash payments to connected person or entities control by them. We find that concentrated founder ownership is more likely to encourage RPTs that are beneficial for minority shareholders compared to RPTs that lead to their expropriation. This show that due to the significant presence of direct concentrated founder ownership in India, firm's value may be linked to the reputation of the founder and founder encourage the RPTs that are beneficial for shareholders.

We find that firm profitability also acts as an important influencing factor for concentrated founder ownership in performing RPTs. The concentrated founder ownership is positively associated with RPTs in firms with low level of performance. The relationship between concentrated founder ownership and RPTs is more pronounced for firms with low profitability compared to firms with high profitability. We also show that business group firms are positively associated with greater magnitude of RPTs compared to standalone and state-owned firms. This indicates that business group firms have significant operational and financial inter-linkages among group firms and they tend to support the other firms through RPTs.

Our next set of analysis considers RPTs impact on value of firm. We find that RPTs in Indian market have positive association with firm value. This is again consistent with our view that due to direct and long-term investment plan, concentrated founder ownership value is linked with the firms' reputation. Therefore, they will engage in RPTs which will likely to

benefit the firm. We also show that business group firms get more benefited by RPTs. This suggests that operational and financial inter-linkages of business group firms help them to enhance their firm value. We further find that the relationship between RPTs and firm value is more pronounced for firms with high level of concentrated founder ownership compared to firms with low level of concentrated founder ownership.

Our study makes number of contributions to the literature. First, this study provides new insight on RPTs and shows that RPTs are the important channel to increase the value of minority shareholders and can be used when there is a significant direct ownership of the founders. Second, our study to the best of our knowledge is the first in-depth study which addresses the crucial question regarding the nexus between concentrated founder ownership and RPTs in the unique and interesting setup of India. We show that greater ownership by founders is associated with the reputation of the firm and as a result they encourage RPTs, which enhances the firm value. This is a unique finding as compared to other markets as Kang et al. (2014) in Korean market finds that controlling shareholders encourage RPTs that destroy the firm value. Third, we contribute to the literature of business groups by showing that business group firms indulge more in RPTs compared to other firms and they get more benefited by RPTs, as it help them to enhance their firm value. Similar to Gopalan et al. (2007), we find that group firms tend to support the other group firms to avoid default by a group firm.

Fourth, our study contributes to the literature on RPTs. Previous studies provide mixed results as one strand of studies find RPTs as mean of tunnelling (Jian and Wong 2004; Claessens et al. 2006) and links to the negative affect on firm value (Cheung et al. 2006; Kohlbeck and Mayhew, 2010). While, the other strand is more consistent with propping (Jian and Wong, 2010) and links to the positive affect on firm value (Buysschaert et al. 2004; Wong et al. 2015). Such inconclusive results are because of nature of RPTs, as RPTs can be both beneficial and abusive. Our study untangles the inconclusive results by showing that the effect of RPTs on firm value is based on the level of founder ownership and firm type. Finally, this research contributes to the emerging field of research of RPTs by examining a large sample through reliable and more comprehensive data source.

The remainder of the paper is as follows. Section 2 discuss the related literature and develops the hypothesis based on the literature. Section 3 discusses the data sources, presents the

empirical model and methodology. Section 4 presents and discusses the baseline results, results after considering type of RPTs and type of firms and the results of linkage of RPTs and Firm value. Section 5 concludes the paper.

## **2 Literature and Hypothesis Development**

### ***2.1 Concentrated Ownership Structure and Agency Problem***

In the context of concentrated ownership, agency problem arises between the controlling and minority shareholders (Lemmon and Lins, 2003; Roe, 2004). Substantial stake in the firm gives incentive to the controlling shareholders to seek private benefits for themselves at the cost of the minority shareholders (Morck and Yeung, 2004). As the controlling shareholding gets widens, the benefits of expropriation for controlling shareholders becomes more relative to the associated cost (Shleifer and Vishny, 1997; Lemmon and Lins, 2003). The effective control in the firm allows controlling shareholders to decide on firm operations and crucial decision like profit sharing among the shareholders. This issue is further aggravated in the presence of family influence over the firms (Anderson and Reeb, 2003) and weak legal environment (Claessens et al., 2002). The extant literature has documented the negative association between the controlling shareholders and firm value (e.g., Claessens et al., 2000, 2002; Lemmon and Lins, 2003, Lins, 2003), suggesting that their self-serving behaviour undermines the firm performance which destroys the firm value. The controlling shareholding in the context of business groups also raises concern of tunnelling i.e. transferring of resources among the firms to increase their personal benefit (Johnson et al., 2000). Consistence with the view, Bertrand et al. (2002) find that in Indian business groups, controlling shareholders engage in significant amount of tunnelling activity among the group firms. Firms may use internal financial transfers, like inter-groups loans to tunnel the funds from affiliated firms (Jiang et al., 2010). This transaction among the related entity is known as related party transaction.

### ***2.2 Related Party Transactions (RPTs)***

The relatively small literature in the field provides two competing views on RPTs, the agency hypothesis (Cheung et al., 2006; Kohlbeck and Mayhew, 2010) and the efficient transaction hypothesis (Khanna and Palepu, 1997; Chang and Hong, 2000). The agency hypothesis considers RPTs as potential wealth transfer mechanism between the firm and related parties. For example, firms can enter into the purchase or sell transaction with a related party where

price is above or less than the market price. Cheung et al. (2006), in Hong Kong market and Kohlbeck and Mayhew (2010), in US market find that stock market reacts significantly negative upon the disclosure of RPTs; which indicates the negative effect of RPTs on firm value. Cheung et al. (2009) find evidence of unfavourable prices among the related parties purchase and sell transactions. Ryngaert and Thomas (2012) also shows transaction that happen after the firm becomes related party are more likely to be used for tunnelling the firm profit. Few empirical studies also show that the agency cost between controlling and minority shareholders also arise due to RPTs, especially in emerging economies due to its weak legal environment. Johnson et al. (2000), Jian and Wong (2004), and Claessens et al. (2006) have shown evidence of tunnelling, by controlling shareholders for extracting the private benefits from minority shareholders.

In contrast to agency hypothesis, the efficient transaction hypothesis considers RPTs as value maximizing transactions. RPTs can help firms to reduce the transaction cost and can be used as an efficient mechanism under incomplete information and underdeveloped capital markets (Stein, 1997; Khanna and Palepu, 1997; Shin and Park, 1999). Buyschaert et al. (2004) and Wong et al. (2015) find that stock market reacts significantly positively to related party transactions in the for Belgian and Chinese market respectively; which indicates the positive effect of RPTs on firm value. Jian and Wong (2010) find evidence of propping through RPTs, which act as beneficial for minority shareholders. Chan and Hong (2000) shows that business group firm can achieve the economies of scale by sharing the tangible and intangible resources among the affiliated firms. Loan and cash received from the related parties also used to prop up the firm value and these RPTs are likely to be beneficial for the minority shareholders (Friedman et al., 2003).

### ***2.3 Controlling shareholders and RPTs***

Controlling shareholders in firms with concentrated and complex ownership arrangement, protect themselves from outside disciplining forces resulting in expropriation of minority shareholders (Cronqvist and Nilsson 2003; Claessens, et al., 2002; Bebchuk, et al., 2000). In addition the presence of pyramidal and cross-holding structure in emerging economies, allows controlling shareholders to gain full control in the firm and further discourage minority shareholders to monitor them. Lack of strong legal environment may aggravate the expropriation of minority shareholders through self-dealing RPTs and transferring of resources among the firms to increase their personal benefit. Concentrated and complex

ownership arrangement makes it more difficult for minority shareholders to scrutinize these transactions. As a consequence of these, firms with concentrated founder ownership (controlling shareholding) have an opportunity to do RPTs, to transfer of resources among the related parties. Hence, based on above discussion, we hypothesize

Hypothesis H1: There is a positive relationship between the concentrated founder ownership and RPTs.

The presence of pyramidal and cross-holding structures, allows the controlling shareholders to have more controlling rights than their equity ownership (La Porta et al. 1999). The more control rights than cash flow rights make controlling shareholders to control the firm even at low level of equity ownership. Therefore, they have very low alignment interest with the minority shareholders (Burkart et al., 1997, 1998; Bebchuk et al., 2000). However, one still can mitigate the entrenchment problem of controlling shareholders by high controlling owner's shareholding in the firm because beyond the threshold it reduces the problem of separation of control and ownership (Claessens, et al., 2002). Such a scenario is in India, where founders control the firm through direct large ownership. This is quite clear from our average concentrated founder ownership which is 53%. Moreover, presence of significant direct concentrated ownership, family firms and business groups in India makes firm's value of these firms directly associated with the reputation of the promoting family (Smith and Amoako-Adu 1999; Wiwattanakantang 2001). If the controlling shareholders try to extract cash flow, outside investors will discount share prices and the controlling shareholders will end up holding a large proportion of shares at a discounted price (Wiwattanakantang 2001). Therefore, we argue that in India the concentrated founder shareholders will engage more in the RPTs which will likely to benefit the minority shareholders compared to RPTs likely to expropriate the minority shareholder. Hence, based on above discussion, we hypothesize

Hypothesis H2: There is a positive relationship between the concentrated founder ownership and RPTs which are likely to benefit minority shareholders.

As we discussed in the above section, RPT's literature suggest two alternative explanations for RPTs, the agency perspective (Cheung et al., 2006; Kohlbeck and Mayhew, 2010) and the efficient transaction perspective (Khanna and Palepu, 1997; Chang and Hong, 2000). Agency perspective consider RPTs as an opportunistic device used by the controlling shareholders to tunnel the resources outside the firm (Johnson et al., 2000; Jian and Wong, 2004; Claessens et al., 2006). Thus, agency perspective suggests that RPTs might have a



negative effect on firm value. The alternative view of efficient transaction perspective consider RPTs as efficient mechanism for reducing transaction cost and overcoming the difficulties in enforcing contracts under incomplete information and underdeveloped capital markets (Stein, 1997; Khanna and Palepu, 1997; Shin and Park, 1999). RPTs in the under developed capital markets where transaction costs are more might bring the efficiency; encourage long-run business relations, bring down uncertainty in business environments and thereby reduces firms' risks (Khanna and Yafeh, 2005). Hence, this perspective suggests that RPTs might benefit shareholders and may lead to positive effect on firm value and we consider this to be the case in context of India. If we consider the above discussed hypothesis, in Indian context, controlling shareholders, mainly families and business groups are more concerned about the firm reputation. Reputation becomes very important in the less developed capital market and trust-based relationships are fundamental to business (Khanna and Palepu, 2000). Controlling shareholders, due to their significant shareholding and long-term investment plan, will consider a firm's prosperity as an extension of their own well-being and this long-term horizon enhances the concerns about firms' reputation. Therefore, they will engage in the RPTs which will likely to benefit the firm. Hence, based on above discussion, we hypothesize

Hypothesis H3: There is a positive relationship between the RPTs and firm value

### **3 Data and Methodology**

We draw our data from the Prowess database managed by Centre for Monitoring Indian Economy (CMIE) which is equivalent to Compustat in US. Prowess database and its classifications have been used extensively in the previous literature for e.g. Khanna and Palepu (2000), Gopalan et al., (2007). Our sample includes all NSE listed firms from year 2002 through 2015. Financial firms were excluded from the sample as banks are exempted from disclosure of RPT. The final sample comprises 12,245 firm year observations. We winsorize all continuous variables at 1st percentile and 99th percentile values to avoid the influence of outliers.

To analyse the relationship between related party transactions and controlling shareholding, we use ratio of amount of related party transactions to total asset as the major dependent variable in our analysis. We divide the related party transactions into operating and non-operating transactions. Operating transactions includes trading activities such as sales and purchases of products and services, while non-operating transactions includes non-trading

activities such as sales and purchase of plant, property and machine. We further divide the related party transactions based on its effects on minority shareholders (Cheung et al. 2006). We classify the transactions that are likely to result in expropriation of minority shareholders (asset acquisitions, asset sales, and cash payments to connected person or entities control by them) and transactions that are likely to benefit the minority shareholders (cash and loan receipts from connected parties and subsidiary trading relationships).

The main explanatory variable used in the analysis is controlling shareholding, which is defined as concentrated founder ownership. To examine the impact of controlling shareholders for different type of firms, we also divided the firms into different categories of business groups, standalone and state-owned firms. Based on prior literature (Kang, et al., 2014; Jian, & Wong, 2010) our study also considers following firm level control variables in the analysis. RPT's are expected to have positive relationship with the Firm size (FSIZE), as firm gets larger and complex they may have more RPT's transactions. We measured FSIZE as natural logarithm of total assets. Market to book ratio is expected to have a positive relationship with the RPT's, as growth firms have higher incentive to manage earnings through RPT's to avoid negative earnings surprise (Skinner, & Sloan, 2002). We measure MB as total asset plus the market value of equity minus book value of equity over total asset. RPT's are more likely to happen in high levered (LEV) firms, as high debt firms are more likely to manage earnings using RPT's to refrain from any debt agreement violation (DeFond, & Jiambalvo, 1994). We measure LEV as ratio of total borrowings and total assets. Return on asset (ROA) is expected to have a negative relationship with RPT's, as firms with bad performance will have more incentive to manage earnings via RPT's (Skinner, & Sloan, 2002). Jian and Wong 2010 also report that firms with marginal earnings also tend to use RPT's to manage their earnings. We thus include ROA and AVOID as control variables. We measure ROA as ratio of net income and total assets and AVOID as dummy variable which is equal to 1 if  $0 < ROA < 2\%$  or else equal to 0. Research and Development (RD) is expected to have positive relationship with RPT's, as it was highlighted in the literature that RD setup of the firms is associated with the RPT's of the firm (Gordon et al., 2004). We measure RD as ratio of research and development expenses and total assets. We also use the proportion of independent director in the board (INDDIR) as the proxy for good governance, as Gordon et al. (2004) reports the importance of board of directors in RPT's. The firms with more independent directors in the board are expected to limit the RPT's in order to protect the

minority shareholders. We measure INDDIR as ratio of the number of independent directors to total number of directors in the board.

We use the panel data methodology to analyse the relationship between related party transaction and controlling shareholding. We use the following model for our study

$$RPT_{i,t} = \beta_0 + \beta_1 CONOW_{i,t} + \beta_2 INDDIR_{i,t} + \beta_3 FSIZE_{i,t} + \beta_4 MB_{i,t} + \beta_5 LEV_{i,t} + \beta_6 ROA_{i,t} + \beta_7 RD_{i,t} + \beta_8 AVOID_{i,t} + Year_t + IndDum + \varepsilon_{it} \dots \dots \dots (1)$$

where RPT is the dependent variable represented as the ratio of amount of related party transaction to total asset and CON\_OWN is the main independent variable measured as the percentage of concentrated founder ownership. INDDIR, FSIZE, MB, LEV, ROA, RD and AVOID are control variables. Year and IndDum represents the year and industry dummies in the analysis to account for the industry and time-related effects.

We use the following model to examine the relationship between RPTs and firm value

$$TOBINSQ_{i,t+1} = \beta_0 + \beta_1 RPT_{i,t} + \beta_2 FSIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 ROA_{i,t} + \beta_5 RD_{i,t} + \beta_6 SALES\_GRW_{i,t} + \beta_7 FAGE_{i,t} + Year_t + IndDum + \varepsilon_{it} \dots \dots \dots (2)$$

Tobin's Q (TOBINSQ) is the dependent variable defined as market value of equity plus book value of debt divided by firm total assets and RPTs is the main independent variable. FSIZE, LEV, ROA, RD, SALES\_GRW and FAGE are control variables. We define SALES\_GRW as sales at year t minus sales year t-1 by sales at year t-1 Year, FAGE as natural logarithm of firm age since incorporation and rest of variable definitions are same as discussed in equation 1. Year and IndDum represents the year and industry dummies in the analysis to account for the industrial and time-related effects. Consistence with the literature (Kang et al., 2014) we have used a lead value of Tobin's Q in the analysis.

## 4 Results

### 4.1 Descriptive Statistics

Table 1 presents the descriptive statistics of the sample firms. The mean value of dependent variable RPT in our sample is .250. Operating RPT (RPT\_OP) and non-operating RPT

(RPT\_NOP) mean value is .094 and .0227 respectively. It is worth notable that magnitude of non-operating RPT is more than the operating RPT. The mean value of subsidiary trading (SUB\_TRA), Loan received (LOAN\_RE), Loan given (LOAN\_GI), connected sales (CONT\_SA) and connected purchase (CONT\_AQ) is .065, .046, .053, .006 and .013 respectively. The concentrated founder ownership has a mean value of 53%, which shows significant presence of direct ownership of controlling shareholders in Indian firms. Among the control variables, the mean value of firm size (FSIZE) is 8.496, the mean value of market to book ratio (MB) is 1.687, the mean value of leverage (LEV) is .343, the mean value of ROA is .035, indicating that in the sample period, firms make a profit of about 3.5% of total assets. Table 2 represents the correlation matrix among the variables and shows that all the variables are significantly related to RPTs. Concentrated founder ownership, market to book ratio and leverage are positively related to RPTs, while proportion of independent directors, firm size and return on assets are inversely related to RPTs.

#### ***4.2 Concentrated founder ownership and RPTs***

In this section, we use Equation (1) to test our hypothesis. Table 3 reports the results, Model 1, shows that the coefficient of CONOW is positively and significantly related RPT. This result shows the positive association between the concentrated founder ownership and RPTs which supports our hypothesis. This result suggests that concentrated founder ownership exerts a significant positive influence on RPTs decisions of Indian firms. This result is consistent with our argument that concentrated and complex ownership arrangement makes it more difficult for minority shareholders to inspect RPTs and firms with controlling shareholding have an opportunity to perform RPTs transaction. Model 2 and Model 3 exhibit the results of operating RPTs (RPT\_OP) and non-operating RPTs (RPT\_NOP) as dependent variable respectively. For both operating and non-operating RPTs, the coefficient of CONOW is positive and significant. This indicates that both operating and non-operating RPTs are positively associated with concentrated founder ownership, but co-efficient of CONOW is greater for operating RPTs compared to co-efficient of CONOW for non-operating RPTs. This suggests that concentrated founder owners encourage more operating RPTs in the firms opposed to non-operating RPTs which are considered more suitable for tunnelling activity as it involves more subjective judgement and discretion than operating transactions (Bertrand et al., 2002). The control variables in Table 3 are mostly consistent with our prediction. Specifically, we observe that proportion of independent directors (INDIR) has a significantly negative effect on RPTs suggesting that independent directors in a board try to limit the RPTs

in the firm. Market to book (MB) has a significantly positive effect on RPTs, suggesting that growing firms are more likely to use RPTs. Leverage (LEV) also has a significantly positive effect on RPTs, pointing that firms are more likely to use RPTs as their financial risk increases. Return on asset (ROA) has a significantly negative effect on RPTs, suggesting that high profitable firms are less likely to manage their earnings by using RPTs.

#### ***4.3 Concentrated founder ownership and type of RPTs***

In this section, we examine the impact of concentrated founder ownership on type of RPTs. We use the definition of Cheung, Rau, and Stouraitis (2006) for dividing the RPTs based on its consequences towards minority shareholders. We classify them into two categories: first, RPT transactions that are likely to result in expropriation of minority shareholders which includes acquisition of assets (CONT\_AQ), sale of assets (CONT\_SA) and cash payments (LOAN\_GI) to connected persons or entities controlled by them. Second, RPT transactions those are likely to benefit the minority shareholders which includes cash and loan receipts from connected parties (LOAN\_RE) and trading relationship with subsidiaries (SUB\_TRA). Table 4, Model 1 and Model 2 reports the results of RPTs likely to benefit minority shareholders i.e. trading relationship with subsidiaries (SUB\_TRA) and cash and loan receipts from connected parties (LOAN\_RE) as dependent variable respectively. For both SUB\_TRA and LOAN\_RE, the coefficient of CONOW is positively and significant. This shows that coefficient of CONOW is positively and significantly related to RPTs that are likely to benefit minority shareholders. Model 3, 4 and 5 report the results of RPTs that are likely to expropriate minority shareholders i.e. acquisition of assets (CONT\_AQ), sale of assets (CONT\_SA) and cash payments (LOAN\_GI) to connected person or related entities. The coefficients of CONOW are positive and insignificant. This shows that the coefficient of CONOW is positively and insignificantly related to the RPTs that are likely to expropriate minority shareholders. These results indicate that concentrated founder ownership is more likely to encourage RPTs that are beneficial for minority shareholders compared to RPTs that leads to their expropriation. This result is consistent with our hypothesis that, due to the significant presence of direct concentrated founder ownership in India, firm's value is linked to the reputation of the promoter and if they try to extract the private cash flows, outside investors will discount share prices and as controlling shareholders have significant stakes in the firm, will result holding the stocks at discounted price. Hence, controlling shareholders is positively and significantly related to RPTs that are likely to benefit minority shareholders

#### ***4.4 Type of firms and RPTs***

In this section, we examine the impact of type of firms on RPTs. We serially introduce the type of firm's dummies while controlling for firm specific variables in Table 5. In Model 1, we introduce the variable for business group firms (BG); we find that the coefficient of BG is positive and significant. This shows that business group firms are positively associated with the magnitude of RPTs in the firm. This result is in line with the view that business group firms have significant operational and financial inter-linkages and they tend to share the risk among the firms (Khanna and Yafeh, 2005) by helping member firms to overcome the constraints on raising external capital (Hoshi, et al. 1991). Group firms tend to support the other group firms to avoid default by a group firm, which will consequently have a negative spillover to the rest of the group (Gopalan et al. 2007). In Model 2 and 3, we include dummy variables for standalone firms (SA) and state owned firms (SO) respectively. The coefficient of both the variables SA and SO are negative and significant. This shows that standalone firms and state owned firms both are negatively associated with RPTs and prevent the firms from related transactions. This may be due to the distinct characteristic of tight rules and regulations of the state owned firms which may restrict themselves from RPTs. Standalone firms as compared to business group firms doesn't belong to any business group and may not have much incentive to support the other firms through related transactions.

#### ***4.5 Profitability, RPTs and concentrated founder ownership***

In this section, we explore the role of firm profitability in understanding the relationship of concentrated founder ownership and RPTs. Firms with poor profitability will have more incentive to manage earnings through RPT's (Skinner, & Sloan, 2002). The firms which reports zero or marginal earnings also tend to use RPT's more often to manage their earnings (Jian and Wong, 2010). Similarly, related parties may also try to provide support to non-performing firms. In the case of group firms Gopalan et al (2007), find that intragroup loans are typically used to support financially weaker firms. Thus, we expect that concentrated founder ownership will positively influence the RPTs more in firms with lower profitability. To test this argument, we partitioned the sample based on the level of profitability of the firms. We group the top 33% firms as high profitable firms, bottom 33% firms as low profitable firms. We examine the relationship between the concentrated founder ownership and RPTs for firms with low vs. high profitability. Table 6 reports the results of the analysis. Model 1 shows the results for firms with low profitability and the coefficient of concentrated

founder ownership is positive and significant. While, in the case of high profitability firms (Model 2), the coefficient of concentrated founder ownership is positive and insignificant. This indicates that concentrated founder ownership exerts a significant positive influence on RPTs in firms with low level of profitability compared to firms with high level of profitability. This result is consistent with our argument that concentrated founder owners tends to indulge more in RPTs in firms with low level of performance and the relationship between concentrated founder ownership and RPTs is more pronounced for firms with low profitability compared to firms with high profitability.

#### ***4.6 RPTs and Firm Value***

So far we provide evidence of positive association between the concentrated founder ownership and RPTs. We also find that concentrated founder ownership is positively associated with RPTs which are beneficial for minority shareholders arguing that this will enhance the value of the firm. Therefore to examine the direct evidence on firm value, in this section we examine the impact of RPTs on firm value.

Table 7 reports the result of the analysis. In Model 1, the coefficient of RPT is positive and significant, which shows that there is a positive association between the RPTs and Tobin's Q. This suggests that RPTs in the Indian market enhances the value of the firm. This may be because of concentrated founder ownership, due to their significant shareholding and long-term investment plan they will consider a firm's prosperity as an extension of their own well-being and this long-term horizon enhances their concerns about firms' reputation. Therefore, they will engage in RPTs which is likely to benefit the firm. We also find that business group firms are getting more benefited by RPTs as the interaction term of RPT\*BG is positive and significant in Model 3. This suggests that operational and financial interlinkages of business group firms help them to enhance their firm value.

#### ***4.7 RPTs, Firm Value and level of concentrated founder ownership***

In the above section we find that RPTs have positive association with firm value arguing that large holdings and long-term investment plan of concentrated founder ownership enhances their concerns about firms' reputation and they engage in RPTs which is likely to benefit the firm. To support our argument, in this section, we explore the role of concentrated founder ownership in understanding the relationship between RPTs and firm value. We expect that RPTs will have positive influence on firm value in firms with higher concentrated founder

ownership because firms with higher concentrated founder ownership will have higher concerns about firms' reputation and they tend to engage more in RPTs that will benefit the firm. To test this argument, we partitioned the sample based on the level of concentrated founder ownership in the firm. We group the top 33% firms as high level concentrated founder ownership firms, bottom 33% firms as low level concentrated founder ownership firms. We examine the relationship between the RPTs and firm value for firms with low vs. high level concentrated founder ownership. Table 8 report the results of the analysis. Model 1 shows the results for the firms with high level of concentrated founder ownership and the coefficient of RPT is positive and significant. While, in the case of low level of concentrated founder ownership firms (Model 2) the coefficient of concentrated founder ownership is positive and insignificant. This indicates that RPTs exert a significant positive influence on firm value in firms with high level of concentrated founder ownership compared to firms with low level concentrated founder ownership. This result is consistent with our argument that concentrated founder ownership tends to indulge in RPTs which will enhance the value of the firm for firms with high founder ownership and the relationship between RPTs and firm value is more pronounced for firms with high level concentrated founder ownership, compared to firms with low level concentrated founder ownership.

## **5 Conclusion**

Using a unique and interesting setting of direct founder ownership and business groups this study examines the relationship between concentrated founder ownership and RPTs and explore on which type of RPTs is affected by concentrated founder ownership and the effect of RPTs firm value. Our study provides new insight on RPTs and shows that RPTs can be used as a channel to increase the value of minority shareholders, when there is a significant direct founder ownership. Our results show that concentrated founder ownership has a significant positive influence on RPT decisions of Indian firms and they tend to encourage more operating RPTs in firms opposed to non-operating RPTs.

We find that concentrated founder ownership is more likely to encourage RPTs that are beneficial for minority shareholders compared to RPTs that leads to their expropriation. We also show that RPTs in the Indian market have positive association with the value of firm. This suggests that in the presence of direct ownership, business groups and family firms makes firm's value of these firms directly associated with the reputation of the founder and their long-term investment plan makes their value directly linked with firm value. Therefore,



they will engage in the RPTs which will likely to benefit the shareholder and firm. We further find that the relationship between RPTs and firm value is more pronounced for firms with high level concentrated founder ownership compared to firms with low level concentrated founder ownership.

We find that firm profitability also acts as an important influencing factor for concentrated founder ownership in performing RPTs. The concentrated founder ownership is significantly positively associated with RPTs in firms with low level of profitability compared to firm with high level of profitability. This suggests that founders lend hands to poor performing firms. We show that business group firms are positively associated with the magnitude of RPTs in comparison to standalone and state-owned firms. We also find that business group firms get more benefited by RPTs. This suggests that operational and financial inter-linkages of business group firms help them to enhance their firm value.

Overall, our result suggests that reputation incentive plays a very important role for concentrated founder ownership and due to the significant direct ownership they align their interest with minority shareholder and encourage the RPTs which are beneficial for them. We find supportive evidence of efficient transaction hypothesis and find that RPTs can be used as an efficient mechanism under incomplete information and underdeveloped capital markets, thus increasing the firm value. Our finding provides insight to the policymakers as due to the perceived negative affect of RPTs, regulators around the globe try to limit and impose restrictions on RPTs but regulators should consider firm characteristics like ownership structure and type of firms before making any decision because these factors can determine the nature of the RPTs. The results of our study can be extended to firms in other Asian economies in which significant direct founder ownership is present.

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## Appendix I Variable Definition

Variable	Definition
RPT	Total amount of related party transactions by total assets of the firm
RPT_OP	Amount of related party sales and purchases by total assets of the firm
RPT_NOP	Amount of related party non-operating transactions by total assets of the firm
SUB_TRA	Amount of transactions between a company and its subsidiaries by total assets of the firm
LOAN_RE	Amount of loans received by the company from the related party total assets of the firm
LOAN_GI	Amount of loans provided by the company to the related party by total assets of the firm
CONT_SA	Amount of sales between a company and connected person or a private company controlled by the connected person by total assets of the firm
CONT_AQ	Amount of purchases between a company and connected person or a private company controlled by the connected person by total assets of the firm
CONOW	Percentage of equity held by concentrated founder ownership (promoter ownership)
INDDIR	Ratio of the number of independent directors to total number of directors in the board
FSIZE	Natural logarithm of total assets
MB	Total asset plus the market value of equity minus book value of equity over total asset
LEV	Ratio of total borrowings by total assets
ROA	Ratio of net income by total assets
RD	The ratio of research and development expenses by total assets
AVOID	Dummy variable equal to 1 if $0 < ROA < 2\%$ else equal to 0
TOBINSQ	Market value of equity plus book value of debt by total assets of the firm
FAGE	Natural logarithm of firm age since incorporation
SALES_GRW	Sales at year t minus sales year t-1 by sales at year t-1

**Table 1**  
**Descriptive Statistics**

This table presents the descriptive statistics for the main variables used in this study across the entire sample period. For each variable, we report the sample average, standard deviation, 25<sup>th</sup> percentile, median, 75<sup>th</sup> percentile and number of observations. The sample consists of all firm-years from 2001 to 2015 of the all listed firms in NSE.

Variable	Mean	SD	P25	Median	P75	Obs
RPT	0.2509	0.4185	0.0230	0.1056	0.2945	12245
RPT_OP	0.0942	0.1930	0.0043	0.0194	0.0927	12245
RPT_NOP	0.0227	0.0599	0.0000	0.0025	0.0163	12245
SUB_TRA	0.0659	0.1263	0.0010	0.0156	0.0681	6286
LOAN_RE	0.0463	0.1041	0.0015	0.0117	0.0438	2909
CONT_SA	0.0060	0.0262	0.0000	0.0000	0.0008	2529
CONT_AQ	0.0134	0.0368	0.0002	0.0016	0.0096	2768
LOAN_GI	0.0538	0.0998	0.0027	0.0156	0.0585	5284
CONOW	0.5302	0.1622	0.4276	0.5376	0.6525	12245
INDDIR	0.4724	0.1168	0.4000	0.4615	0.5455	12245
FSIZE	8.4963	1.6063	7.3975	8.3504	9.4477	12245
MB	1.6877	0.9980	1.1340	1.3549	1.8172	12245
LEV	0.3432	0.2975	0.1667	0.3141	0.4534	12245
ROA	0.0359	0.0920	0.0081	0.0369	0.0749	12245
RD	0.0023	0.0062	0.0000	0.0000	0.0010	12245
AVOID	0.1728	0.3781	0.0000	0.0000	0.0000	12245

**Table 2**  
**Correlation Matrix**

This table presents the correlation matrix for the main variables used in this study across the entire sample period. The sample consists of all firm-years from 2001 to 2015 of the all listed firms in NSE. The bold correlation coefficients are statistically significant at 1% level. Detailed variable definitions are provided in Appendix “I”.

	RPT	RPT_OP	RPT_NOP	CONOW	INDDIR	FSIZE	MB	LEV	ROA	RD	AVOID
RPT	1										
RPT_OP	<b>0.6665</b>	1									
RPT_NOP	<b>0.3725</b>	<b>0.101</b>	1								
CONOW	<b>0.0642</b>	<b>0.0835</b>	<b>0.0259</b>	1							
INDDIR	<b>-0.0674</b>	<b>-0.085</b>	-0.0105	<b>-0.1302</b>	1						
FSIZE	<b>-0.0675</b>	<b>-0.0292</b>	<b>0.0557</b>	<b>0.0978</b>	<b>-0.0539</b>	1					
MB	<b>0.0837</b>	<b>0.1039*</b>	<b>0.1646</b>	<b>0.1505</b>	<b>-0.0419</b>	<b>0.222</b>	1				
LEV	<b>0.0296</b>	<b>-0.0953</b>	<b>-0.0586</b>	<b>-0.1445</b>	<b>0.035</b>	<b>-0.1651</b>	<b>-0.2927</b>	1			
ROA	<b>-0.039</b>	<b>0.0936</b>	<b>0.043</b>	<b>0.1489</b>	-0.0197	<b>0.1437</b>	<b>0.3792</b>	<b>-0.4923</b>	1		
RD	-0.0118	<b>0.0461</b>	<b>0.0267</b>	0.007	<b>0.0548</b>	<b>0.1202</b>	<b>0.1963</b>	<b>-0.1137</b>	<b>0.116</b>	1	
AVOID	-0.0118	<b>-0.0358</b>	-0.0105	-0.0164	<b>0.0402</b>	0.007	<b>-0.1627</b>	<b>-0.0444</b>	<b>-0.0669</b>	<b>-0.0745</b>	1

**Table 3**  
**Concentrated founder ownership and RPTs**

This table reports the regression estimation between related party transaction and controlling shareholding. Model 1, 2 and 3 represents the results using RTP (Total RPTs), RPT\_OP (operating RPTs) and RPT\_NOP (non-operating RPTs) as dependent variable respectively. Detailed variable definitions are provided in Appendix “I”. All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	(1) RPT	(2) RPT_OP	(3) RPT_NOP
CONOW	0.1411*** (5.70)	0.0532*** (4.81)	0.0088** (2.39)
INDDIR	-0.1626*** (-5.08)	-0.1069*** (-7.47)	-0.0019 (-0.41)
FSIZE	0.0042 (1.43)	-0.0029** (-2.20)	0.0030*** (6.74)
MB	0.0370*** (7.95)	0.0111*** (5.35)	0.0070*** (10.07)
LEV	0.0655*** (4.38)	-0.0314*** (-4.69)	0.0038* (1.73)
ROA	-0.1994*** (-4.17)	0.0607*** (2.84)	-0.0052 (-0.74)
RD	-1.0867 (-1.47)	0.4523 (1.37)	0.0848 (0.77)
AVOID	-0.0014 (-0.15)	-0.0092** (-2.11)	-0.0001 (-0.05)
Constant	0.2537*** (3.05)	0.2188*** (5.89)	-0.0244** (-1.97)
Observations	12,245	12,245	12,245
R-squared	0.169	0.219	0.102
Year FE	YES	YES	YES
Industry FE	YES	YES	YES



**Table 4**  
**Concentrated founder ownership and type of RPTs**

This table reports the regression estimation between related party transaction and controlling shareholding. Panel A represents the results using transactions that are likely to benefit minority shareholders. Model 1 and 2 represents the results using SUB\_TRA (subsidiaries trading) and LOAN\_RE (loan receipt by the related parties). Panel B represents the results using transactions that are likely to expropriate minority shareholder. Model 3, 4 and 5 represents the results using CONT\_SA (sales between a company and connected person or firm controlled by connected person), CONT\_AQ (purchase between a company and connected person or firm controlled by connected person) and LOAN\_GI (loan given to the related parties) respectively. Detailed variable definitions are provided in Appendix “I”. All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	Panel A		Panel B		
	Transactions likely to benefit minority shareholders		Transactions likely to expropriate minority shareholders		
	(1)	(2)	(3)	(4)	(5)
	SUB_TRA	LOAN_RE	CONT_SA	CONT_AQ	LOAN_GI
CONOW	0.0218** (2.05)	0.0444*** (3.48)	0.0012 (0.31)	0.0018 (0.35)	0.0044 (0.46)
INDDIR	-0.0202 (-1.42)	-0.0162 (-0.97)	-0.0066 (-1.49)	-0.0066 (-1.00)	-0.0058 (-0.47)
FSIZE	0.0050*** (3.66)	-0.0120*** (-7.70)	-0.0023*** (-4.74)	-0.0021*** (-3.25)	-0.0042*** (-3.69)
MB	0.0101*** (5.47)	0.0119*** (4.20)	0.0004 (0.62)	-0.0001 (-0.13)	0.0062*** (3.58)
LEV	0.0123 (1.45)	0.1211*** (14.96)	0.0073*** (2.91)	-0.0013 (-0.29)	0.0233*** (3.38)
ROA	0.0689*** (3.03)	-0.0591** (-2.36)	0.0260*** (3.40)	0.0230* (1.72)	-0.0740*** (-3.85)
RD	0.3307 (1.09)	-0.4663 (-1.18)	-0.0911 (-0.85)	-0.2973** (-2.01)	-1.1262*** (-3.82)
AVOID	-0.0060 (-1.48)	-0.0094** (-1.98)	-0.0007 (-0.45)	0.0012 (0.61)	0.0058 (1.57)
Constant	0.0197 (0.55)	0.1114*** (2.93)	0.0143 (1.01)	0.0318* (1.76)	0.0539* (1.91)
Observations	6,286	2,909	2,529	2,768	5,284
R-squared	0.209	0.287	0.151	0.158	0.161
Year FE	YES	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES	YES

**Table 5**  
**Type of firms and RPTs**

This table reports the regression estimation between related party transaction and controlling shareholding. Model 1, 2 and 3 represents the results using business group firms (BG), standalone firms (SA) and state owned firms (SO) respectively. Detailed variable definitions are provided in Appendix "P". All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	Business group firms	Standalone firms	State-owned firms
	(1) RPT	(2) RPT	(3) RPT
CONOW	0.1429*** (5.80)	0.1316*** (5.33)	0.1489*** (5.99)
BG	0.0876*** (10.48)		
SA		-0.0869*** (-10.00)	
SO			-0.0949*** (-3.12)
INDDIR	-0.1756*** (-5.51)	-0.1674*** (-5.25)	-0.1703*** (-5.31)
FSIZE	-0.0037 (-1.21)	-0.0050 (-1.63)	0.0061** (2.01)
MB	0.0367*** (7.91)	0.0369*** (7.96)	0.0367*** (7.88)
LEV	0.0650*** (4.36)	0.0670*** (4.49)	0.0628*** (4.19)
ROA	-0.1872*** (-3.93)	-0.1780*** (-3.73)	-0.2067*** (-4.32)
RD	-1.4463** (-1.96)	-1.3729* (-1.86)	-1.1032 (-1.49)
AVOID	-0.0022 (-0.22)	-0.0010 (-0.10)	-0.0020 (-0.21)
Constant	0.2697*** (3.26)	0.3687*** (4.41)	0.2392*** (2.87)
Observations	12,245	12,245	12,245
R-squared	0.176	0.176	0.169
Year FE	YES	YES	YES
Industry FE	YES	YES	YES

**Table 6**  
**Profitability, RPTs and concentrated founder ownership**

This table reports the regression estimation between related party transaction and controlling shareholding. Based on the ROA of firms we group the top 33% firms as high profitable firms, bottom 33% firms as low profitable firms. Panel A represents the results using low profitable firms and Panel B represents the results using high profitable firms. Detailed variable definitions are provided in Appendix “I”. All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	Panel A	Panel B
	Low profitable firms	High profitable firms
	(1)	(3)
	RPT	RPT
CONOW	0.2315*** (4.88)	0.0169 (0.37)
INDDIR	-0.0246 (-0.39)	-0.3227*** (-5.63)
FSIZE	0.0126** (2.05)	-0.0125** (-2.27)
MB	0.0674*** (5.36)	0.0254*** (3.66)
LEV	0.1028*** (4.55)	0.0151 (0.42)
ROA	-0.4151*** (-5.06)	0.2398* (1.90)
RD	-0.6485 (-0.36)	-1.6265 (-1.46)
Constant	-0.1904 (-1.18)	0.8192*** (5.31)
Observations	3,339	4,375
R-squared	0.263	0.219
Year FE	YES	YES
Industry FE	YES	YES

**Table 7**  
**RPTs and Firm Value**

This table reports the regression estimation between firm valuation and related party transaction. Model 1, 2 and 3 represents the results using TOBINSQ (Tobins Q) as dependent variable. BG represents the business group firms and RPT\*BG represents the interaction term of RPT and BG. Detailed variable definitions are provided in Appendix “I”. All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	(1) TOBINSQ t+1	(2) TOBINSQ t+1	(3) TOBINSQ t+1
RPT	0.1321*** (6.77)	0.1325*** (6.76)	0.0854*** (2.73)
BG		-0.0033 (-0.18)	-0.0215 (-1.06)
RPT*BG			0.0762* (1.92)
FSIZE	0.0973*** (15.86)	0.0975*** (15.42)	0.0972*** (15.36)
LEV	0.5289*** (17.46)	0.5290*** (17.46)	0.5291*** (17.47)
ROA	0.7700*** (14.29)	0.7700*** (14.29)	0.7687*** (14.27)
RD	7.5303*** (20.86)	7.5339*** (20.84)	7.5234*** (20.81)
SALES_GRW	0.1066*** (7.93)	0.1066*** (7.92)	0.1061*** (7.89)
FAGE	0.0163 (1.14)	0.0167 (1.15)	0.0171 (1.18)
Constant	-0.3176* (-1.84)	-0.3192* (-1.84)	-0.3096* (-1.79)
Observations	11,877	11,877	11,877
R-squared	0.346	0.346	0.346
Year FE	YES	YES	YES
Industry FE	YES	YES	YES

**Table 8**  
**RPTs, Firm Value and level of concentrated founder ownership**

This table reports the regression estimation between firm valuation and related party transaction. We formulated the groups based on the controlling shareholding of firms. We group the top 33% firms and bottom 33% firms as firms with high level and low level of controlling shareholding. Model 1 and 2 represent the result using LOW and HIGH level of CONOW respectively. Detailed variable definitions are provided in Appendix “T”. All regressions control for industry and year fixed effects. t-statistics are in brackets. \*\*\*, \*\*, \* denote significance at the 1%, 5%, and 10% significance level, respectively.

VARIABLES	LOW CON_OWN	HIGH CON_OWN
	(1)	(3)
	TOBINSQ t+1	TOBINSQ t+1
RPT	0.0310 (0.91)	0.2451*** (6.34)
FSIZE	0.0462*** (5.03)	0.1571*** (11.90)
LEV	0.7264*** (19.39)	-0.0526 (-0.61)
ROA	0.5013*** (7.52)	0.7850*** (6.65)
RD	13.0572*** (7.92)	6.9281*** (15.66)
SALES_GRW	0.1157*** (6.02)	0.0771*** (3.17)
FAGE	0.0673*** (2.83)	-0.0224 (-0.79)
Constant	-0.2383 (-0.89)	-0.8086** (-2.02)
Observations	3,651	3,932
R-squared	0.444	0.433
Year FE	YES	YES
Industry FE	YES	YES