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Analysis of the Related Party Transactions in terms of managerial and financial issues for the Kenyan Savings and Credit Cooperatives

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Abstract

Related party transactions are a key factor to the sustainability of Savings and Credit Cooperatives (SACCOs). In view of this fact, loans to directors and staff are viewed as a factor which can greatly influence savings and credit cooperatives into either falling into financial distress or helping them to remain a float and become financially stable entities. The stakeholder theory holds that entities should be managed a manner that will satisfy every stakeholder. The stewardship theory reiterates that managers have the organisation at heart and can it to profitability as if it were their own. However approval of loans and other transactions to managers and staff, may not positively impact the entity. This study was designed to establish the effect of related party transactions on the relationship between board characteristics and financial distress of deposit taking SACCOs in Nairobi County. We applied Descriptive research design on Deposit taking SACCOs in Nairobi County which was identified purposively while a census was conceded for all deposit taking SACCOs in the county. We obtained secondary data from SASRA using a data collection sheet after which we performed panel data analysis by use of STATA software. Findings were presented using tables. The study concluded that related party transactions influenced the relationship between board characteristics and financial distress of Deposit Taking SACCOs in Nairobi County. Related party transactions can be an avenue of causing financial distress and should be kept as low as possible. The regulator should come up with a tool based on Altman's Z score models to predict financial distress in SACCOs in order to offer timely advice to alleviate more distress and consequent bankruptcy which may lead to closure of SACCOs. Another research may be carried out to establish other factors causing financial distress and how to turn around the SACCOs already in distress.

Keywords: finance; related party transactions; Savings and Credit Cooperatives; management

JEL Classifications: D10; D14

Introduction

The Kenyan financial sector has been dogged with a number of challenges among them financial distress. Corporate governance has contributed to this problem immensely especially due to the characteristics of the boards that govern these institutions. The Kenyan SACCO subsector is among these financial institutions. Theoretical and empirical literature indicates that financial distress is majorly caused by corporate governance and especially board characteristics in many institutions in the world (Bergman et al., 2012). SACCO's are very instrumental in developing the economy of any country since they help to mobilize money assets from low income earners, nurture liquidity and uphold proper functioning of the SACCO's financial system (Kamau, 2016).

Ooko et al. (2013) established that SACCOs on average suffer financial distress consistently while Gikuri and Paulo (2016) urge that SACCOs suffer financial distress due to excessive donor dependency while Odhiambo (2011) and Otieno et al. (2015) contend that SACCOs suffer financial distress due to existence of opportunities to mismanage such entities. Mwaura (2005) indicated that some actions of the board of directors may distress the performance of the SACCOs. In the current study, the researcher endeavored to find out the relationship between board characteristics and financial distress of Deposit taking SACCOs in Nairobi County.

Financial distress has been defined to encompass circumstances whereby a business organization experiences impediments in paying off its financial contracts, and in particular, those of its creditors (Kariuki, 2013). It means that there is a tight cash situation (insolvency) and if prolonged may occasion bankruptcy or liquidation. Financial distress may not force a firm into bankruptcy and liquidation. It could just mean that the firm is experiencing an unfavorable and risky position financially (Aasen, 2011). Corporate financial distress can also be taken to mean a situation where a corporate organization experiences extreme lack of liquidity that cannot be rectified without serious restructuring of business operations and capital structure (Jaafar et al., 2018).

Corporate governance of which board characteristics is part of has been of great concern hence becoming a frequent feature in various corporate meetings, often featured in the media as well as other stakeholder groups (Subramanian, 2015). The Recent financial crunches, corporate failure, fraudulent financial reporting, as well as failure to report have been a point of discussion in such corporate meetings (Brown & Caylor, 2006). Giant corporations such as Enron, WorldCom, Parmalat, Arthur Andersen, Freddie Mac, HealthSouth and Tyco International have also not been spared. These corporate failures have had hostile outcome on share prices, capital markets and investors' confidence considering that investors have lost sums of money in relation to their investments. The board also assists members and other stakeholders to instigate measures of ensuring that the concerns of members as well as that of other stakeholders are addressed. This is achieved through separation of ownership and control functions and the resultant agency problem that calls for the board of directors to effectively and efficiently carry out their oversight routines (Elad et al., 2018). A co-operative has been defined by the International Cooperative Alliance as an independent conglomeration of individuals voluntarily united to fulfill common social, cultural and economic objectives through a jointly-owned and democratically-controlled business.

The SACCOs are financial institutions which are part of the cooperative movement of Kenya which can further be divided into two major categories or subdivisions. Financial co-operatives (Savings & Credit Co-operative Societies- SACCOs) and Non-financial cooperatives (includes farm produce and other commodities marketing cooperatives, housing, transport and investment co-operatives).

The Financial Services Bill of 2016 aimed at promoting and enhancing the safety and soundness of prudentially-regulated financial institutions, enhancing and supporting the efficiency and integrity of financial markets, promoting public confidence in and encouraging development of the financial sector, and protecting financial clients through promotion of fair handling of financial clients by economic entities (Government of Kenya [GOK], 2011). However, previous findings such as that by Kiaritha (2015) have shown high failure rate (51 percent) of SACCOs with three (3) in every seven (7) of the licensed Deposit Taking SACCOs (DTS) having their deposit-taking licenses revoked due to perpetual negligence in addressing non-conformity matters which both exposed members' interest earned on their deposits as well as financial endurance of the deposit-taking enterprise. Related party transaction is described as a transfer of resources or obligations between related parties, whether this transfer is expressed in monetary terms or not. A related party can be described as a party who can control or have influence on an entity or a party that is controlled or owned by the entity specified (Idrees & Qayyum (2018).

Literature Review

This section reviewed relevant theories and also relevant past studies and came with appropriate hypothesis to guide the research. Board Characteristics are regarded as a blend of characteristics which can be possessed by members of a formal group which may regulate decisions of an entity. These comprises of age, gender, education, experience, diversity among others (Wayne et al., 2010).

SASRA (2015) reiterates that the board is also responsible for setting the apex tone by requiring management to uphold the standards so set which exhibits the firm's promise of reliability as well as compliance with legal requirements. The tone establishes the foundation for an organizational culture which is then transmitted to the workforce at every level of the entity. It is also the responsibility of the board to approve, implement and monitor strategic plans of the organization. The board can achieve this by having considerable input in the organization's strategic plan right from inception to execution. It is also expected to approve the organization's strategic plans and must frequently assess the execution of such strategies which are intended to generate lasting value whilst evaluating the risk inherent in the strategic plans and finding solutions to them at the same time.

For a company which has experienced financial distress, the role of the board and the responsibilities of individual directors transform to other essential techniques as compared to the same roles and responsibilities when the company had not fallen into financial problems (Rechden & Miller, 2015). A case in point is where the owners and other stakeholders assume that the board will apply a more practical strategy than in the past in an attempt to position that firm back to being financially health and being profitable. Board characteristics are among various elements which may influence financial performance of corporates consequently leading to financial distress. Conclusions on the various researches conducted in the area of corporate governance point out to the need for more research to establish how board characteristics influence a firm's financial performance which may in turn cause firms to be financially distressed (Manzaneque et al., 2016). Among the many board characteristics, this research focuses only on board independence, board size, board diversity, board independence, Education qualifications of board members and board tenure.

It is necessary that the board should make certain that its composition factors relate to geographical distribution, gender parity, occupation, ethnicity, age, work experience and academic achievements of the directors. Further, it is also required that as a standard measure of ensuring that the board observes stipulations for guaranteeing suitably qualified individuals being recommended or nominated for appointment to the board that a nominating committee is instituted and its roles involves all facets of the appointment of SACCO's directors (SASRA, 2015).

The agency theory advocates the existence of progressively large number of outside directors in the boards as this helps in controlling as well as limiting the opportunistic character of managers stemming from their skill, objectivity and independence essential for the control function. It is further argued that the existence of external directors (non-executive) enhances efficiency such that the concern has more disclosures to make. Birjandi et al. (2015) reiterated that majority of external directors in a board enhance the oversight and efficiency of fiscal disclosures and reduced earnings resultant of withholding information. The composition of the board may influence the performance of a SACCO though its relationship is found to be positive. However, it is worth noting that boards comprised of more external directors may assist in mitigation of the agency problem by curtailing on the managers opportunistic behavior (Oguku & Olweny, 2016).

According to Gordon et al. (2004) RPTs aids organizations to curtail transaction costs with other parties and therefore it significantly moderates the correlation of corporate governance and the performance of firms listed in Indonesian stock exchange. Conversely, Pozzoli and Venuti (2014), Magdalena and Dananjaya (2015), and Downs et al. (2016) find that RPTs do not significantly affect the relationship between political affiliation and firm performance. Due to the inconclusiveness of the literature, the current study concentrates on the establishment of the moderating effect of related party transactions on the relationship between Board Characteristics and Financial Distress of Deposit taking SACCOs in Nairobi County. Based on these arguments, the study proposed the following hypothesis:

H0: Related Party Transactions do not significantly moderate the relationship between board characteristics and financial distress SACCOs in Nairobi County.

Research Methodology and Results

The study used descriptive longitudinal research design. A longitudinal research is conducted over long time (could be decades). In this form of research, an aspect is observed iteratively. The research entailed collecting and analysing secondary panel data for the 2012 – 2018 time period, on deposit taking SACCOs in Nairobi County and therefore this research design was deemed most apt for the study on sample of 43 Savings and credit cooperatives drawn purposively from a population of 174 deposit taking SACCOs in Nairobi County, Kenya with the related party transactions being measured by the proportion of loans to directors on total loans issued by the SACCO.

The researcher undertook a descriptive data analysis, in order to capture a general picture of the raw data. In particular, the following metrics about the data for all variables were computed: mean maximum, minimum, variance, standard deviation, skewness, and kurtosis. The mean indicates the average value of all recorded observations, while the maximum shows the highest recorded observation for each variable. Further, the minimum indicates the least recorded observation for each variable. Variance and standard deviation are measures of dispersion which show the variability of the observations about the mean. Further, skewness indicates whether the observed values were conforming to a symmetrical distribution or were skewed, either positively or negatively. Finally, kurtosis indicates the level of peakedness of the observed values.

Table 1: Descriptive Statistics

| | Mean | Maximum | Minimum | Variance | Standard Deviation | Skewness | Kurtosis |
|----------------------------------|--------|---------|---------|----------|--------------------|----------|----------|
| Financial Distress | 1.870 | 6.644 | -19.332 | 3.242 | 1.801 | -5.553 | 7.659 |
| Board Size | 6.929 | 9.000 | 5.000 | 1.643 | 1.282 | 0.065 | 1.993 |
| Board Composition | 0.314 | 0.600 | 0.111 | 0.022 | 0.148 | 0.324 | 1.841 |
| Board Independence | 0.469 | 0.857 | 0.111 | 0.053 | 0.231 | 0.037 | 1.677 |
| Board Average Level of Education | 1.968 | 2.500 | 1.500 | 0.104 | 0.323 | 0.275 | 1.797 |
| Board Tenure | 5.570 | 15.783 | 1.009 | 12.013 | 3.466 | 1.011 | 3.360 |
| Related Party Transactions | 0.0187 | 0.080 | 0.000 | .000254 | .0159 | 2.258 | 7.999 |

From table 1, it is evident that the independent variable (Financial Distress, as measured using the Altman's Z score) had a mean of 1.87, which is quite low and thereby implies that on average, deposit taking SACCOs operating in Nairobi County is financially distressed. The maximum observation for the Altman's Z score is 6.644, while the least is -19.332. The dependent variable has a relatively low extent of variation since the variance is 3.242 and the standard deviation is 1.801. Additionally, it can be seen that this variable is negatively skewed (Skewness = -5.553), thereby implying that most of the observations were less than the mean. Further, the kurtosis is quite high (kurtosis = 7.659). This implies that majority of the observed values for Altman's Z score either coincided with the mean or was very close to the mean.

In order to conceptualize the intrinsic relationship between the studies independent, moderating, and intervening variables, correlation analysis was undertaken. Another essence of this procedure was to evaluate the strength of linear interrelationships between these variables, thereby precluding the problem of multicollinearity. Results of correlation analysis are as shown

Table 2: Correlation Analysis

| | Board Size | Board Composition | Board Independence | Board Average Level of Education | Board Tenure | Related Party Transactions |
|----------------------------------|------------|-------------------|--------------------|----------------------------------|--------------|----------------------------|
| Board Size | 1 | | | | | |
| Board Composition | 0.0527 | 1 | | | | |
| Board Independence | 0.0835 | -0.0713 | 1 | | | |
| Board Average Level of Education | 0.0559 | 0.0512 | -0.0105 | 1 | | |
| Board Tenure | 0.038 | 0.1317 | 0.0196 | 0.0527 | 1 | |
| Related Party Transactions | 0.2064 | 0.0644 | 0.0603 | -0.0326 | -0.104 | 1 |

As shown in table 2, all the indicators did not have any excessive levels of strong correlation. Thus, they can be jointly fitted as regressors in panel models. From the table, it is evident that board size has a positive correlation with other indicators of board characteristics as well as firm revenue and external borrowing. Board composition has a negative linear relationship with board independence and external borrowing, but a positive relationship with other indicators. Board independence has a negative relationship with the Board Average Level of Education but a positive relationship with all other variables. Further, Board Average Level of Education was found to have a negative correlation with Related Party Transactions and External Borrowing but a positive relationship with the other variables. Board tenure has negative relationship with Related Party Transactions.

Diagnostic tests are pre estimation procedures that evaluate whether the assumptions of Ordinary Least Squares (OLS) panel regression analysis are upheld. In particular, a strong linear relationship should not exist between any variables that are fitted jointly as regressors in a model (no multicollinearity), there should be panel level stationarity, error terms should be linearly independent (no autocorrelation), the variance of the error terms should be constant (no heteroscedasticity), and the error terms should be normally distributed (with a mean of zero and a constant variance). These assumptions and the particular tests that were used to test for each of them are discussed in detail as follows:

The test for multicollinearity indicates that there was no linear relationship amongst the indicators of the independent variable and the moderating variable. This is ascertained from the fact that all variables had a VIF of below 10, and a tolerance that exceeded 0.1

Table 3: Testing for Multicollinearity

| Variable | VIF | Tolerance |
|----------------------------------|------|-----------|
| Board Size | 1.48 | 0.6754 |
| Board Composition | 2.39 | 0.4176 |
| Board Independence | 2.34 | 0.4277 |
| Board Average Level of Education | 1.03 | 0.974 |
| Board Tenure | 2.52 | 0.3969 |
| IT1 | 9.75 | 0.1026 |
| IT2 | 8.39 | 0.1192 |
| IT3 | 7.45 | 0.1341 |
| IT5 | 6.31 | 0.1585 |
| Mean VIF | 4.27 | |

Since all the values of tolerance are greater than the minimum threshold of 0.1 (Table 3), then the data was deemed to pass the assumption of no multicollinearity.

On Serial Correlation assumption, Wooldridge test for autocorrelation in panel data was used to test whether the study's data conformed to the assumption of no autocorrelation and the results are as shown below:

From the Wooldridge test, it can be seen that there was presence of first order autocorrelation, since this test was statistically significant (p value = 0.0003).

Table 4: Wooldridge test for autocorrelation

| Wooldridge test for autocorrelation in panel data | |
|---|--------|
| H0: no first-order autocorrelation | |
| F(1, 41) = | 12.631 |
| Prob> F = | 0.0010 |

The Wooldridge test for autocorrelation in panel data had a p value which was strongly statistically significant (Table 4). Therefore, the autocorrelation was deemed to be evident in the data this informed the choice of the model. The Likelihood Ratio test was used to test the data for heteroscedasticity and the following results were obtained.

Table 5: Likelihood-ratio Test for Heteroscedasticity

| | | | |
|--------------------------------|-------------|---|--------|
| Likelihood-ratio test | LR chi2(41) | = | 366.56 |
| (Assumption: nested in hetero) | Prob> chi2 | = | 0.000 |

Each violation of CLRM assumptions has a remedy. In instances where there is multicollinearity, the variable with the highest Variance Inflation Factor (VIF) should be excluded from further analysis. In cases of autocorrelation, a PraisWinsten Panel Regression model should be fitted while in cases where there is heteroscedasticity, a normal panel model (but with corrected standard errors) should be fitted. The PraisWinsten procedure generates robust results in the presence of autocorrelation, while the corrected standard errors implement a correction mechanism to reverse the effects of heteroscedasticity, thereby ensuring that the estimators so generated are still BLUE (Best, Linear and Unbiased Estimators). Table 6 shows the results of model fitting. Owing to the presence of autocorrelation and heteroscedasticity, the empirical model for step two of testing the moderating effect of related party transactions was undertaken using the Prais-Winsten panel regression with corrected standard errors as shown in table 6.

Table 6: Panel Regression Results for Step Two of Testing the Moderating Effect

| Prais-Winsten regression, heteroskedastic panels corrected standard errors | | | | | |
|--|----------------------------|-------------------------|---------------|--------------------|----------------------|
| Group variable: | saccoid | | | | = 294 |
| | | | Number of obs | | = 42 |
| Time variable: | year | | | Number of groups | = 7 |
| Panels: | heteroskedastic (balanced) | | | Obs per group: min | = 7 |
| | | | | avg | = 7 |
| Autocorrelation: | panel-specific AR(1) | | | max | = 7 |
| Estimated covariances = | 42 | | | R-squared | = 0.2714 |
| Estimated autocorrelations = | 42 | | | | = 19.94 |
| | | | Wald chi2(5) | | |
| Estimated coefficients = | 11 | | | Prob>chi2 | = 0.0183 |
| FD | Coef. | Het-corrected Std. Err. | z | P> z | [95% Conf. Interval] |
| BS | -0.009 | 0.004 | 2.070 | 0.004 | |
| BC | -1.100 | 1.134 | -0.970 | 0.333 | |
| BI | -1.103 | 0.292 | -3.780 | 0.011 | |
| BE | -0.668 | 0.270 | -2.470 | 0.013 | |
| BT | 0.036 | 0.010 | 3.750 | 0.010 | |
| RPT | 0.515 | 0.223 | 2.310 | 0.021 | |
| IT1 | 0.202 | 0.071 | 2.840 | 0.016 | |
| IT2 | -0.355 | 0.208 | -1.710 | 0.087 | |
| IT3 | -0.316 | 0.087 | -3.630 | 0.010 | |
| IT5 | 2.603 | 0.845 | 3.080 | 0.002 | |
| _cons | 0.009 | 0.004 | 2.070 | 0.004 | |

FD = Financial Distress, BS= Board Size, BC = Board Composition, BI = Board Independence, BE = Board Average Level of Education, BT = Board Tenure, RPT = Related Party Transactions, IT1 = Interaction Term 1, IT2 = = Interaction Term 2, IT3 = Interaction Term 3, IT5 = Interaction Term 5

As evident from table 6, board size, board independence and board education have negative and statistically significant effect on financial distress. Board tenure has positive and statistically significant effect on financial distress. Likewise, the moderation variable and all interaction terms, except IT2 and IT3 have positive and significant effect on the dependent variable. IT3 has negative and significant effect on the dependent variable. It can also be noticed that there was an increase in the coefficient of determination (R²) after inclusion of the interaction terms, i.e. from 26.66% to 27.14%. Therefore, the moderating effect of related party transactions on the relationship between board characteristics and financial distress is deemed present; because the value of the coefficient of determination (R²) increases after inclusion of the interaction terms.

As such, null hypothesis two that related party transactions do not significantly moderate the relationship between board characteristics and financial distress of deposit taking SACCOs in Nairobi County, was rejected in favor of the alternative hypothesis that related party transactions have a moderating effect on the relationship between board characteristics and financial distress of deposit taking SACCOs in Nairobi County.

The findings are supported by Gordon et al. (2004) who contend that related party transactions are non-beneficial and value reducing for shareholders. It can also be noted that management use related party transactions both to direct wealth to themselves and to come up with deceptive financial statements (Kohlbeck & Mayhew, 2010). Gordon et al. (2004) and Abdul et al. (2018) are among other studies which hold a similar opinion.

Kim et al. (2019) and Aharony et al. (2005) are other studies which hold the opinion that related party transactions are negatively related to firm performance and can therefore encourage financial distress. However, Zakaria et al. (2017) are of a different opinion that related party transactions impact firm performance positively albeit the effect varies according to the parties involved.

Conclusion

SACCOs need to have lean boards, since board size was found to have detrimental effects on financial distress. Board composition should also be improved in terms of the number of female members, due to the fact that this helps in forestalling financial distress. Additionally, there should be more inclusion of independent members on SACCO boards since this indicator has an inverse relationship with financial distress. Further, there should be deliberate inclusion of members with high and relevant education credentials, since this attribute was found to be helpful in curtailing financial distress. Moreover, board tenure was found to have a positive relationship with financial distress. Therefore, SACCO boards should have term limits for their members to allow fresh members periodically, who are likely to inject new ideas into the boards' decision making mechanism. The study further recommends that related party transactions should be kept at a bare minimum, since they were found to have a moderating effect on the relationship between board characteristics and financial distress.

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