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Resource Allocation and Related Transactions of Listed Company: Based on Perspective of the Implicit Transaction Costs

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Abstract: The implicit related-party transaction has its own particularity on the background of Chinese listed companies. It has strong significance of study the implicit related-party transaction. The study thinks that the related party transaction within the group of decrease implicit transaction costs but increased the cost of small shareholders. Hidden costs have stronger influence on hidden related party transactions. Hidden costs increase agency costs but the relationship between the hidden costs and the size of related party transactions is uncertain. So it is necessary to distinguish related-party transactions from the point of normative research.

Key words: Related party transaction, implicit transaction costs, explicit transaction costs, incomplete contract

INTRODUCTION

The related party transaction (abbreviation RPT) refers to the matters of transferring resources or obligation among listed company as well as its holding subsidiaries and related parties, whether it charges at the present stage or not. At present, connected transactions exist widely in daily business activities of listed companies and have quite a few connected transactions belong to unfair connected transactions in listed companies of China (Dietrich, 1999; Yugang and Shanmin, 2007). As a form of transactions, the related party transaction has unique two-faced. The performance of two-faced is that RPT is a widespread trade form from the perspective of system formed and exists certain advantages of cost saving relative to the independent market transaction. In background of group company, RPT can be regarded as a relatively optimal trade form that the listed company gain own benefit maximization (Shleifer and Daniel, 2002). On the other hand, although emphasize on equal trading but due to separation of the control and cash flow right, in order to seek for their self-interest, the controlling shareholder inevitable invade on the minority shareholder's interests through the unfair the related party transaction. Since a violation, in order to maintain the unreasonable interests, the controlling shareholder will take some way to make this trade form that not easy for supervision of small investors and external found, then it must appear implicit transaction (Comes, 2001). The study research distinguishes implicit transaction costs and explicit transaction costs of related party transaction.

RESOURCE ALLOCATION AND RELATED LISTED COMPANY

Combined with the actual Chinese listed companies, at present, the implicit related-party transaction are several kinds of main form. First, the related party relationships turn into the correlation properties which will change virtual connected transaction hidden. Due to the presence of chain pyramid structure, both parties of trade remain the same ultimate control. The transaction still belongs to the connected transaction in nature but this kind of trade relationship is harder to find. Secondly, through the choice of transaction time which can change virtual connected transaction be hidden. When the listed company transactions with a party, at this time the transaction party is not a listed company's related party (Enriques and Volpin, 2007). In accordance with the provisions of the regulation of listed companies, this transaction shall belong to the normal fair market trading. Thirdly, it is hiding relationship. For the determination of related transactions, legal requirements not existing affiliated parties. When it has practical control key decision makers in the management level, the relationship will be concealed. Fourth, the monetization trading is converted. At present there are a large amount of non monetization deal between the listed company and an associated person. Although the implicit connection transaction can escape the supervision, non monetization deal still to be supervised by monetization trading standards. At this time the listed company still going hidden transaction through the monetization trading is converted (Berkman *et al.*, 2009).

Based on view of transaction cost economics, market and enterprises is two different of resource allocation way that can be substitute mutually. In the market, trading is determined by the pricing mechanism. Through the pricing mechanism, resources can be the rational allocation. But it emerges cost through the pricing mechanism organization; establishment of an organization can reduce transaction cost. Different of the pricing mechanism, entrepreneurs use administrative orders replace price mechanism which become motivation of resource allocation and make market transaction internalization namely the emergence of enterprises is to save transaction costs (Dietrich, 1999). Further, if enterprise regarded as mechanism of resource allocation to save cost better than ever market mechanism or pricing mechanism, then enterprise should be enlarged unlimitedly in maximum profit motives and eventually make whole economy into a large enterprise which completely replaces the market. However, the enterprise is not unlimited increase, the enterprise and the ways coexist and interdependent, namely the enterprise has its boundaries. In the process of enterprise expansion, enterprise's organization cost and the management cost is increased. When a transaction cost of the enterprise organizations equals to the transaction cost through open market exchange manner, the enterprise will stop expansion, namely it is the boundary point which enterprise substitution market (Yugang and Shanmin, 2007). As the resource allocation way, enterprise and market has its operating cost. If trading costs of using market mechanisms to coordination is bigger coordination costs of using internal trade of enterprise, it will appear mergers and integration between enterprises in order to replace market transaction trading. Similarly, If the coordination costs inside enterprise is bigger than transaction costs using market mechanisms, transactions occur by contract way between independent enterprises (Shleifer and Daniel, 2002). But if using a single trading cannot reduce corresponding cost, new coordinated manners will appear which has characteristics of the market and business organization. The manners take advantages of market mechanism and the enterprise mechanism. The manner is called middle organization form and associated enterprises is this typical of form.

COST SAVING AND RELATED PARTY TRANSACTIONS

Enterprise's goal is to maximize profit and there are several ways to achieve this goal. Usually, general trading can be divided into two types: the enterprise internal transactions and business transaction. The enterprise

internal transactions include products transfer between different departments. Strictly speaking, the deal is a broad sense the appellations, it is actually a kind of management coordination behavior. At present, many large enterprise simulating market behavior in the enterprise internal established a cost center in order to realize the enterprise interior settlement or assessment but this is not true market transactions, it is a kind of cost management mode (Comes 2001). The latter is sales elements or product in enterprise. But for affiliated enterprises, in addition to the above two types of existing trading outside, there exists a kind of special trade form- Related Party Transactions (RPT). Different of general enterprise's independence, though in the legal sense each affiliated enterprise is commercial subjects of independent and has the corresponding legal personality but due to the existence of the unique relationship between them, the transaction will normally be serving specific economic purposes, which differs from trading of independent enterprises under the market mechanism. Because of the particularity of RPT, RPT has a function of save transaction cost and become a influence factors of enterprise's implement.

According to theory of the transaction cost economics, if the market transaction costs is bigger than in the same trade expenses of enterprise internal organization, the market trade internalization behavior can appear in order to reduce transaction cost. Conversely, if coordination costs of organization is bigger than transaction costs of using market mechanism, enterprise will maintain the original contract way (Enriques and Volpin, 2007). But, as t two ways of allocation of resources, market mechanism and enterprises organizations has its own advantages and has the corresponding running costs but both the advantages and disadvantages is a kind of complementary relationship. Therefore, if it adopted market transaction and internal trade means of resource allocation, it will undoubtedly reduce effectively of corresponding charge. This is RPT between affiliated enterprise. Though affiliated enterprise legally status is equal and has an independent legal personality but in fact its status is often not equal because there exist relations of equity, contracts, personnel control etc. One side is usually substantially control ability or both sides is controlled by third party. Due to the special relationship between affiliated enterprise's existences, the information asymmetry and opportunism behavior existing in transactions between independent enterprises will be eased, supervision cost of negotiation, contract signing and the implementation will be reduced significantly and its transaction costs will be lower than average costs of

market transaction. Meanwhile, affiliated enterprise is a enterprise legal person of separate property, interests and management of an independent, its operating performance is relatively independent and easy to determine, therefore, it can keep the stimulation motivation and the pressure of competition of market offering. Therefore, RPT a trade form in the midst of market transactions and enterprise internal organization which is able to reduce the market transaction costs and save cost of organization. It satisfied with affiliated enterprise's intrinsic demand of reduction cost and pursuit of profit, thus RPT become widespread between affiliated enterprises (Berkman *et al.*, 2009).

IMPLICIT TRANSACTION COSTS ANALYSIS MODEL OF THE RELATED TRANSACTION

Case compared transaction costs and organizational cost and practical implied a hypothesis: they has the same goal. For this theory, the experts questioned. Dietrich says that corporate boundaries shall also consider from benefit of enterprise organization to bring, rather than just consider the cost savings. In his opinion, even if the transaction cost is higher but combination produced benefit is lower, at this time market substitution doesn't happen to enterprise. The boundary of enterprise is determined of comparing costs and benefits. At this time, the explicit costs of market trade is bigger than explicit costs of organization but due to different of the benefit, there are still unlikely happen to substitution of enterprise to market. Dietrich says that in consideration of substitution of enterprise to market, it also should consider other factors besides comparing transaction cost and organizational cost. RPT is largely substitution of enterprise to market but benefits of RPT often do not contradiction in alternative market. Scale effect of RPT may enhance the benefits of he listed company and its affiliates. At this time, it is necessary to introduce implicit cost to analyze the problem of RPT (La Porta *et al.*, 2003).

Implicit transaction costs of the related transaction: Every transaction has a contract with the corresponding and the listed companies largely reduce transaction costs through RP. The existence of Contract doesn't only the benefits of commodity exchange. It is more important that benefit that the adjustment of cost of property right influence the adjustment of the benefit which is Implicit of actual products. In considering Implicit cost, the listed company faced multiple choice of incomplete information, asymmetric opportunism conflict and transaction cost minimization when it choose the affiliated party. The

internalization related transactions can largely achieve of balance of contract costs and regulatory costs. But if considered implicit cost, this conclusion may not established. RPT is a kind of trade form of the enterprise group's internal alternative market transactions. RPT and implicit RPT get cost savings improve interests of its controlling shareholders and others through transaction implicit and explicit cost saving.

As a kind of the control mechanism of enterprise internal, RPT is actually a cooperative mechanism of internalization that controlling shareholder decrease uncertainty and enhance trust. This mechanism can reduce the transaction costs in the market and reduce the opportunity cost and organizational cost which enterprise integration brings. As the connection transaction increases, it actually increased a new transaction cost and now still faced a balanced problem. Based on the analysis of governance structure, system design includes implicit cost and explicit cost. Explicit costs are happened through market mechanism implicit cost is a kind of benefit through the organization structure design to obtain. Chinese listed companies often have group backdrop of state-owned property right and has the pyramid structure and cross-share holdings structure. At this time, the controlling shareholders can gains the balance of benefit and cost with RPT. As a kind of balance, implicit cost either is positive or negative. When sum of implicit cost and explicit cost is bigger than zero, RPT is reasonable and can replace the market mechanism. Conversely, if sum of them is less than zero, the added RPT is not economic (Tian, 2012). For RPT, on the one hand it is becoming implicit, on the other hand it can save implicit cost and explicit cost. For implicit RPT, it can expand research perspective of implicit RPT through comparing the sum of implicit cost and explicit cost. This study argues that explicit cost of RPT is the cost of using the market mechanism, implicit cost is a profit comparison of RPT through the internal market.

From the perspective of implicit cost, the means of the affiliated enterprise's non-affiliated, the connection transaction time delay, the currency of RPT and establish bridge company increase the difference between the income and cost in the listed company. Ostensibly, complex organizational design increases the directly cost of RPT to the ascension but essentially, this implicit RPT also promote the implicit cost of market trade. If the market mechanism is more perfect, explicit cost can be reduced and necessity of RPT can be decline. If the organization structure of group as pyramid structure, cross-share holdings structure methods play a role and increase the implicit cost, RPT including implicit RPT alternative of the market trade will ascend.

The hidden costs under the perspective of agency cost:

Chinese listed companies generally existed the second agency problems namely big shareholders interests infringed to small shareholders'. Unfair RPT is the main way of benefit expropriation. In order to safeguard the rights and interests of small shareholders, agency cost problem will inevitably exists. From the implicit cost perspective, implicated RPT existing, there are two deal with cases for the small shareholder (Miao, 2012). A situation is: owing to implicated RPT, small shareholders may not be able to find its own interests infringed and reduced regulatory enthusiasm. Now the agency cost will decline. Another situation is: owing to implicated RPT, small shareholders need to invest more cost of supervision because of difficult of find increasing, so, the agency cost will rise. From the perspective of implicit cost, agency cost in fact plays the role of reduced RPT occurs. Whether small shareholders or big shareholders, they belonged to the listed company. The agency cost increased means organization cost of listed company increased. Organization cost increased reduce the implicit cost of RPT, possibilities of RTP occurred decline. But for the implicit RPT, because there are two kinds of possibility, there is the possibility of RPT to implicit cost, so there is uncertainty of RPT. As show in Fig. 1.

In Fig. 1, the vertical axis means transC2 means monitor expenses. TC1 mainly includes contract negotiation, information exchange an action cost, the horizontal axis means scale of transaction cost, TC1 means negotiations fees, Td other fees, TC2 includes the relevant interests protection fee and normal operation cost of disputes. According to the institutional economics, as the trade scale expand, correlation between each other has enhancement and TC2 is declined. But because affiliated party has its own independent economic benefits, for its own interests, TC1 will increase as expansion of the scale of the trade. So total Transaction Cost (TC) is sum of TC2 With TC1. TC 's change is a u-shaped change associated with business

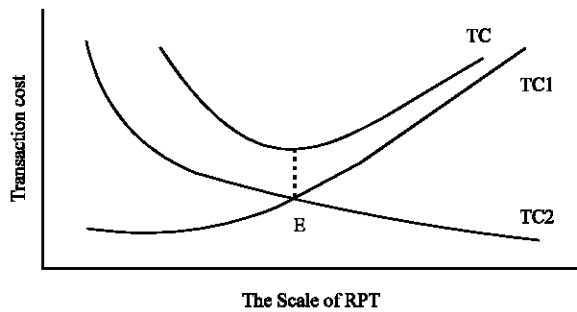


Fig. 1: Associated the related party transaction relationship with explicit transaction cost

scale which began to drop, then rise. From Fig. 1, it can be seen that trading scale is bigger, TC1 is bigger and the rate of TC1 is increasing. Accordingly, to increase the rate of TC2 is decreasing. In figure 1, E means the balance of trade size. But considering of implicit cost, the conclusion will change and affiliate transaction costs is different of considering implicit cost.

- **Case 1 implicit cost increased:** As shown in Fig. 2, TCs means implicit cost, T means explicit cost, TC* means total cost. Along with TCs increased, the difference between the organization's benefit and cost that controlling shareholders can gain is increased with RPT. Along with the increase of related transaction scale, TCs is decreased. As explicit cost costs of RPT be constant, TC * is gradually declined with the increase of related transaction scale. At this time, for listed companies and the controlling shareholder is concerned, existence of RPT is inevitable
- **Case 2 implicit cost decreased:** As shown in Fig. 3, along with TCs decreased, the difference between the organization's benefit and cost that controlling shareholders can gain is decreased with RPT. Along with the increase of related transaction scale, TCs is increased. As explicit cost costs of RPT be constant, TC* is gradually inclined with the increase of related

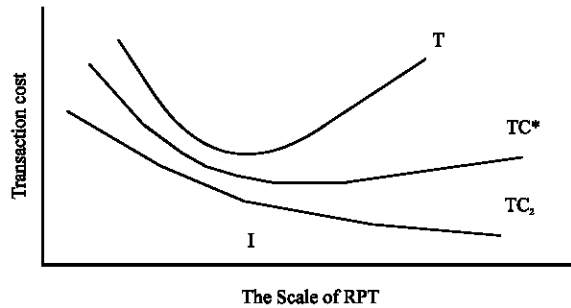


Fig. 2: Implicit transaction costs increased

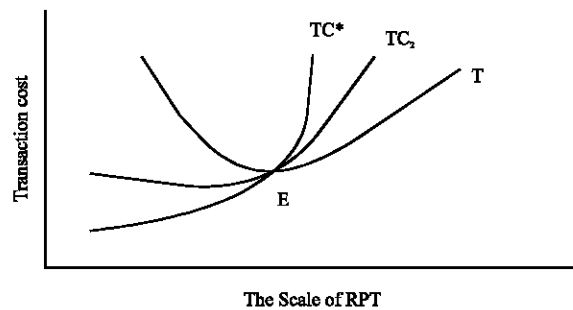


Fig. 3: Implicit transaction costs declined

transaction scale. At this time, for listed companies and the controlling shareholder is concerned, the impact of the increasing the scale of RPT to total cost is not big as the scale of RPT is less. At this time the listed companies can gain some of the currency revenue such as increase employment associated with internal group trades under the background of the state-owned. In Fig. 2, E point after, implicit cost play the role of accelerator and make the total cost rapidly increase. From the viewpoint of revenue and cost, then adding RPT will not become economic

The implicit costs under the perspective of opportunity cost: Before the analysis of implicit cost of PRT, it does not consider the problem of opportunity costs. If consider opportunity cost, implicit RPT can improve current capitalization benefits of the listed company. But since resources have diversity, RPT occurs is actually lost opportunities of other profit. In fact, this opportunity's loss become cost comparison, the cost is a kind of opportunity cost also a kind of implicit cost.

Shleifer and Daniel (2002) assuming α means cash flow right of controlling shareholder, Q means the ownership of resources of beginning for listed company, γ means the rate of return of resources and $1+\gamma>0$. Earnings ratio of the controlling shareholders obtained with RPT is R , $1+R>0$ and RPT occurs the current period (Sheng *et al.*, 2011). Cash earnings ratio of the controlling shareholders invest again is α , $1+\beta>0$, ratio of shifting company initial value with RPT is S . At this time, when the income gained through the related party transaction is greater than opportunity cost of related party transaction, the c related party transaction occurs become economic, i.e.,:

$$[S-C(S)]Q(1+R)\beta > SQ(1+r)\alpha$$

$$\alpha(1+r) = \frac{[\beta(1+R)] < 1-C(S)]}{S}$$

The left of type 1 reflects features of the company, the right reflects the benefits and costs' change with related transaction dominated by controlling shareholder. $1-C(S)/S$ and $C(S)/S$ Reflect respectively proportion ratio and cost ratio that controlling shareholder use the RPT. The premise is other influencing factors unchanged, α/β and $(1+\gamma)/(1+R)$ is smaller, the risk of through the unfair related party transaction expropriation of small shareholders get higher. It can be concluded t another conclusion: Companies operating characteristics is important factor that influence controlling shareholder expropriation of the benefit. If only considering direct

costs, it will think that the related party transaction is reasonable but thinking of opportunity cost, the costs of RPT will increase. At this time, the conclusion of the economy of the related party transaction may be changed even if the transaction is fair.

CONCLUSION AND POLICY SUGGESTIONS

As a form of transactions, the related party transaction has unique two-faced. Due to separation of control and cash flow right, the controlling shareholder occupies the minority shareholder's rights and interests with unfair RPT in order to seek for their self-interest. For the sake of interests, controlling shareholders take implicit RPT that is not easy to be found by small investors or external supervision. So, implicit cost has stronger influence to implicit RPT. Implicit cost increased agency cost but the relationship between implicit cost and agency cost e is uncertain. If considering the implicit cost in the analysis of opportunity cost, the cost of RPT actually tend to increase.

With the development of split share structure reforms of listed companies, ownership structure, trading behavior and type of major controller of listed companies have changed greatly. The related party transaction became implicit. This change leads to new changes in behavior of related party transactions. A single model of governance is difficult to achieve the best result. Comprehensive governance can minimize the danger of related party transactions and increase its favorable aspect. The comprehensive supervision and management can avoid the fair related party transaction occurs to greatest degree and protect the interests of small shareholders. Now we will put forward the suggestions in details:

Optimize the ownership structure of listed companies and perfect the protection mechanism of medium and small investors of listed companies: The "one share jumbo" ownership structure and the lack of effective corporate governance structure is the main reason of generating the unfair related party transactions. Therefore, listed companies must put forward the reasonable way of realizing the optimal allocation of ownership structure under the condition of protecting the interests of the medium and small investors. The process of changing the ownership structure is also the process of redistribution of corporate control in essence. The diversified ownership structure can make the personification feature of the joint stock company more evident and then supervise and constrain the behavior of controlling stockholders or actual controllers. Therefore, it reduces the occurrence of behaviors that controlling

stockholders or actual controllers impose their own wills on listed companies and harm the interests of medium and small investors for their own interests by right of their equity advantages. So it is helpful for controlling stockholders or actual controllers and listed companies to change the concept of financing, to improve the utilization efficiency of the equity capital and realize the operation target of the maximization of enterprise wealth. After the reasonable allocation of ownership structure, the perfection of the corporate governance structure should reflect the mutual restriction and supervision of consignor, consignee and administering authority.

Improve the information condition of the capital market: In this study, information condition directly influences the results of the game equilibrium. Generally speaking, amount of information owned by the main bodies of capital market, such as big stockholders, medium and small investors and regulators and other capital market in the game is different in the game process. About the information of the companies' specific management, the big stockholders have the most abundant information, followed by regulators and medium and small investors as well as the public are always at the weak position but the information among them is always incomplete and asymmetric. Although the absolute and asymmetric information can never be reached, the degree of the absolute and asymmetric information can be improved by clearing information supplying channels, improving the ability of absorbing and integrating information and improving the dissemination and transmission mechanisms of information.

Establish the pre-commitment approach: Pre-commitment approach comes from the technical terms of game theory. When used in the regulation of unfair connected transactions of listed companies, it refers to the behaviors that the big stockholders of listed companies make a commitment to regulators in a certain period and prohibit the unfair connected transactions according to the forecast of the possible maximum error. In the range of the maximum forecasting error, listed companies can do self-regulation. If unfair connected transactions exceed the maximum possible error within a certain period, regulators will give certain punishment and strengthen supervision. Compared with traditional supervision methods, Pre-commitment approach has more flexibility. Under this mechanism, the big stockholders of listed companies also have some flexibility. If there is any problem, they cannot shirk their responsibilities. Therefore, it strengthens the conservatism of big stockholders of listed companies on connected

transactions, reduces the supervision cost indirectly and increases the effectiveness of supervision.

Increase the negative act cost of regulators: Negative act cost of regulators actually refers to the behaviors that there is no conclusive evidence but regulators are involved a suspected "conspiracy" in a sense in the regulation of unfair connected transactions, which is showed that regulators find the illegal behavior controlling stockholders encroach the interests of listed companies via unfair connected transactions but do not disclose or avoid responsibility deliberately. This kind of behavior has characteristics of negativity and invisibility. Negative act cost of regulators can be expressed quantitatively using the analysis above. Thus increase the negative act cost of regulators can increase the probability of being discovered of regulators' negative acts, loss of reputation they suffered from and the corresponding material loss. In practice, changing the single assessment of super ordinate appraisal into departments shall be regularly or irregularly common assessments from competent authorities and the public is an important way in optimizing the evaluation mechanism of regulators. Regulators should publish the investigative cases of unfair connected transactions of listed companies in the form of report on a regular basis when they do regular assessments, while irregular assessments mainly regard assessments of the regulators' actions from professionals and the general medium and small investors as the judging basis.

Strengthen legislation and law enforcement, improve the efficiency of securities regulation and increase the construction of punishment mechanism: A strong executive system of law can make up for the deficiency of the stockholders' legal rights. However, the improvement of law enforcement needs upright, professional, independent law-executors, which often takes several decades to complete. In the long term, when legal environment improves, especially the law enforcement improves, law enforcement may be the important mechanism which bans unfair connected transactions, protects the interests of medium and small investors and improves economic efficiency.

The improvement of regulation efficiency and the increase of punishments have substitution effect on suppressing unfair connected transactions. It is difficult listed company to use reparation to relieve this kind of illegal unfair connected transactions. This raises a special claim for the law enforcement of securities. First, law-executors should pay attention to the timeliness when doing the investigations, otherwise the effect will be

constantly expanding and damage may be difficult to relieve. Second, law enforcement must be professional, otherwise it will be difficult to solve some of the complicated problems. At present, the regulatory means of unfair connected transactions is still not flexible enough and with lack of administrative discretion, regulators have difficulty in identifying and dealing with all kinds of unfair connected transaction behaviors. At the same time, regulators are easy to be captured by some interest groups of listed companies for their own interests, which may go against the promotion of the whole social welfare. Besides, medium and small stockholders' equities of the listed companies depend on the government's regulation. As a result, under current conditions, the key to reduce unfair connected transactions is to perfect performance appraisal system and responsibility restraint system and make the regulators independent, professional and with strong incentive mechanism.

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