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Related party transactions and financial distress of Savings And Credit Cooperative Organizations (SACCOs) in Kenya

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ABSTRACT

The widespread failure of DT SACCOs in Kenya is likely to lead to a loss of confidence among the current and potential members of the DT SACCOs in Kenya and eventually threatens to kill the sector. The study examined the effect of related party transactions on financial distress in DT-SACCOs in Kenya; the study adopted the following theories as to the basis of analyzing the collected data; wrecker's financial distress theories and Agency theory. The target population was 176 Deposit-Taking SACCOs. Secondary data was obtained from SACCOs records as published by SASRA. The study used a systematic sampling technique based on the sampling formula by Taro Yamane (1967) to obtain the appropriate sample size of 68 DT SACCOs. Data were analyzed using STATA computer software. Data collection covered seven (7) year period from 2008 -2014, this period of 7 years was selected for the study because SASRA has enacted in 2010 therefore the justification for the choice of the study period, that is 3 years before and 4 years after SASRA enactment. The study established that related party transactions had a significant effect on financial distress in DT SACCOs in Kenya. The implications of the findings are that if the DT-SACCOs do not manage related party transactions then they will continue experiencing financial distress. The government through SASRA therefore should enact strict regulations in directors borrowing from SACCOs. The study has expounded on the body of knowledge on measures of financial distress in finance by introducing new relationships established. In terms of the contribution of the current study to innovation, the study used panel data analysis while other studies used OLS.

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Introduction

In Kenya, the Savings and Credit Cooperative Organizations (SACCO) sub-sector has witnessed rapid growth in the last few years at the rate of about 25% per annum and now boasts of a savings mobilization of Shs.180 billion and an asset base of over KShs.200 billion (CBK, 2014). The savings mobilized by SACCOs represent 31% of the national savings. SACCOs have therefore played a key role in mobilization of financial resources and will be a major player in realization of the national Vision 2030. This sub-sector occupies a strategic position in the socio-economic development of Kenya (Ngaira, 2012). The SACCO sector operates under different regulatory regimes in Kenya with deposit-taking SACCOs being regulated by Sacco Societies Regulatory Authority (SASRA) while non-deposit-taking SACCOs are regulated by the Department of Cooperatives.

Alhadab, Abdullatif, and Mansour (2020) in their study on related party transactions and earnings management in Jordan: the role of ownership structure established that accrual earnings management is negatively associated with related party transactions. Data were collected from Jordanian industrial public-listed companies for the period 2011–2017. Accrual earnings management is measured by using the modified Jones model, whereas real earnings management and related party transactions are measured by using relevant proxies. A regression model is developed and used to assess the relation between related party transactions and earnings management, considering the effects of ownership concentration, family ownership and institutional ownership levels of the companies involved. Regarding the role of ownership structure, the presence of institutional investors is positively associated with using both related party transactions and real earnings management, whereas ownership concentration plays an efficient role to mitigate the use of both accrual earnings management and related party transactions. No statistically significant relations between real earnings management and related party transactions exist.

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This study was conducted in Jordan creating the literature gap that motivated the current study which analyzed the effect of related party transactions on DT-SACCO financial distress in Kenya.

Gordon, Henry and Palia (2004) established that transactions between a firm and its own managers, directors, principal owners or affiliates are known as related party transactions. They studied related party transactions for a sample of 112 publicly-traded companies, including the types of transactions and parties involved. Such transactions, which are diverse and often complex, represent a corporate governance challenge. They first explore two alternative perspectives of related party transactions: the view that such transactions are conflicts of interest which compromise management's agency responsibility to shareholders as well as directors' monitoring functions; and the view that such transactions are efficient transactions that fulfill rational economic demands of a firm such as the need for service providers with in-depth firm-specific knowledge.

On the issue of related party transaction, prudent funds allocation strategy is an important financial practice function in any SACCO society. This aspect usually involves decisions to commit the SACCOs' funds to planned investment options. These decisions have a great influence on the growth of wealth. SACCOs need to make decisions to invest their funds more efficiently in anticipation of expected flow of benefits in the long run. Such investment decisions generally include expansion, acquisition, modernization and replacement of long-term assets (Maina, 2007). In all these cases, the SACCOs should strive to minimize costs and optimize benefits to ensure its operational sustainability, growth in SACCOs' wealth, and attractiveness to potential and present members.

In terms of statutory regulations, the establishment of SACCO Societies Act 2008 places the licensing, supervision and regulation of deposit taking under the ambit of the SACCO Societies Regulatory Authority (SASRA). Through this new legal framework, prudential regulations have been introduced to guide SACCO's growth and development (Barrales, 2012). Deposit taking SACCOs are licensed and regulated by SASRA while non-deposit taking SACCOs are supervised by the Commissioner for Cooperatives. SASRA licenses SACCOs that have been duly registered under the Cooperative Societies Act CAP 490 (SASRA, 2012). The SACCO Societies Regulatory Authority (SASRA) is a creation of the SACCO Societies Act 2008. SASRA is a regulatory body that was constituted and inaugurated in 2009. It is charged with the prime responsibility to license, supervise and to regulate all deposit taking SACCO Societies in Kenya. The SASRA is expected to set the minimum operational regulations and prudential standards for the SACCOs. Nevertheless, some provisions in the Act, such as the minimum capital requirement, are so stringent that some SACCOs may not be able to operate the FOSA activity (Wanyama, 2009).

Although the causes of financial distress are numerous, many failures are attributed either directly or indirectly to management. In the past cooperatives societies have experienced huge impacts of financial distress leading to financial crisis, which have resulted to bankruptcy and liquidation. Arising from the strategic position played by the SACCO sector in the Kenyan economy, it would therefore be prudent to establish the determinants of financial distress in SACCOs in Kenya in order to predict future performance of SACCOs.

Scholars; Kiaritha (2015), Unal, Guclusoy and Franquesa (2009), Bhetuwal (2007), Nyoro and Ngugi (2007) and Pollet (2009) have conducted studies on financial performance within the SACCO movement and using various variables where various factors contributing to success or failure of co-operatives were multifaceted and depended on the operating environment of the specific SACCO. Moreover, these studies evaluated just a handful of factors. However, the impact of related party transactions on DT-SACCOs has not been fully addressed. This study therefore sought to bridge this research gap by ascertaining the effect of related party transactions on financial distress of Deposit Taking SACCOs in Kenya. The study therefore hypothesized that related party transactions have no significant effect on financial distress in savings and credit cooperative organizations in Kenya.

The findings from the study would help to avoid unnecessary declines, bursts and unnecessary receivership of DT SACCOs in Kenya. SASRA as a regulatory body will understand the importance of adjusting their regulations actively. The regulations would help to put financial distress effect to manageable levels. Information acquired from this study would help the investors and customers understand key financial distress determinants in the DT SACCOs in Kenya, likely strength in SACCOs in overcoming the effect of financial distress determinants and how financial distress may lead to the risk of default or otherwise. As a result, they will make informed investment decisions.

This study is organized in terms of the abstract that gives the summary, introduction that introduces the major concepts on related party transactions as a determinant of SACCOs distress, the literature review in terms of the theory considered and related empirical studies, the methodology, findings, implication and conclusions.

Literature Review

Theoretical Review

Wreckers Theory of Financial Distress

Wreckers theory of financial distress After developing a reduced form default risk indicator, Campbell, Hilscher and Szilagyi (2005) present hypothesis that stocks of distressed firms perform in a manner which is vastly inferior to stocks of financially healthy firms. The wreckers' theory of financial distress seeks to explain the benefits that may step out of financial distress to members. The hypothesis is huge in this investigation in setting up the capacity of SACCOs in altering themselves from financial distress to

monetarily reasonable organizations. The adjusting of the different variables finishing into financial distress of the SACCOs would help in reducing the propensity of the organizations to be financially bothered. This theory was the basis upon which the dependent variable of the study, the financial distress was statistically tested.

Agency Theory

Agency theory is developed as framework for analyzing conflicting interests between key stake holders, in addition to the development of mechanisms for resolving conflicts (Tipuric, 2008). Besides prevalent contribution within discipline of corporate governance, agency theory application is extensive: agency theory may be applied in every situation in which one party (the principal) delegates work to another (the agent), who performs that work. Agency theory attempts to describe the relationship in terms of behavioural characteristics. Incentive for agency theory development is the relationship between ownership and control functions within large corporations. Not much studies have tested Agency Theory in Kenyan firms regulated either by Central Bank of Kenya or SACCOs regulated by SASRA regulations as a determinant of financial distress. This theory therefore was used to examine the effect related party transactions on financial distress in savings and credit cooperative organizations in Kenya.

Empirical Review

Many studies have shown that firms are involved in RPTs to prop up the firm or to enhance performance for different purposes, such as: to fulfill government requirements for offering new equity (Jian & Wong 2010; Yeh et al., 2012); to avoid delisting (Jian & Wong, 2010; Peng et al., 2011; Williams & Taylor, 2013); to obtain future financing or repay the RPTs loans (Gordon & Henry, 2005); to decrease the negative effect of industry shock on firm's earnings (Jian & Wong 2010); and to increase earnings (Yeh et al., 2012).

Chien & Hsu (2010) investigated the relationship between related party transaction and firm performance of public companies listed on Taiwan stock exchange within year's 1996- 2006. Collecting information of a sample of 6,041 companies from the Taiwan Economic Journal (TEJ) data. The dependent variable was the operating performance which was measured by Return on Assets (ROA). The independent variable were Related Party Sales(RPS) measured by related party sales divided by total sales, Related Party Purchase(RPP) measured by related party purchase divided by cost of goods sold, Gain on Disposal of Assets from Related Parties (RPAG) measured as gain on disposal of assets from related parties divided by total sales, Loss on Disposal of Assets from Related Parties (RPAL) calculated as loss on disposal of assets from related parties divided by total sales, Related Parties Interest Revenue (RPIR) calculated as related parties interest revenue divided by total sales, Related Party Interest Expense(RPIE) measured by related party interest expense divided by total sales calculated as net income divided by average total sales. Multiple regressions were used to test the relationship between the variables. The result revealed that related party sales, interest revenue and interest expense though negative, were statistically significant and the other variable were negative and insignificant thus it was shown that no relationship exist between related party transaction and firm performance. Their findings support the conflict of interest hypothesis that related party transactions are harmful to the company's interest. This study was done in Taiwan and did not analyze effect of related party transaction on financial distress of DT-SACCOs in Kenya creating literature gap filled by the findings presented in chapter four.

Huang & Liu (2010) in its study of relationship between RPTs and firm value in high technology firms in Taiwan and China between the periods of 1998-2008. The study measured firm value by ROA, ROE, MVA, Tobin's Q. and EVA. Using ordinary least squares method to test its hypothesis, the empirical results show that the account (notes) receivables and account (notes) payables from related-party transactions of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance. However, the sales or purchases of goods from related party transactions of high-technology firms in China have a significant (negative) relationship with performance. The study found that the link between RP sale and purchase of goods in Taiwan companies is insignificant in relation to the variables of performance however accounts (notes) receivable and accounts (notes) payable from RPTs of high-technology firms in Taiwan exhibit a significant (positive) relationship with performance.

Mohammed and Abibakar (2019) examined the impact of related party transactions, off balance sheet items on earnings quality of listed deposit money banks in Nigeria over the period of 4 years (2011 to 2014). The study reveals that related party transactions are positively and significantly related to earnings quality. On the contrary, off balance sheet items were found to be negatively and insignificantly related to earnings quality. Based on the findings, the study concluded that related party transactions have significant impact on the earnings quality of the Nigeria deposit money bank. The study recommends that Management of the Nigeria money deposit banks should be more aggressive towards the number of related party transactions when making financial decision, this is because based on the findings of the study related party transactions do affect earnings quality positively. This study also was done in Nigeria and did not analyze effect of related party transaction on financial distress of DT-SACCOs in Kenya creating literature gap filled by the findings presented in chapter four.

Conceptual Framework

When clearly articulated, a conceptual framework has potential usefulness as a tool to assist a researcher to make meaning of subsequent findings. It forms part of the agenda for negotiation to be scrutinized, tested, reviewed and reformed as a result of investigation and it explains the possible connections between the variables (Durham & Stokes, 2015). Conceptual frameworks are pivotal to research as they clarify and integrate philosophical, methodological and pragmatic aspects of doctoral thesis while helping the profession to be seen as a research-based discipline, comfortable with the language of meta-theoretical debate, (Sykes & Piper, 2015). A conceptual framework for the present study shows the effect of financial distress factors on financial performance of

commercial banks in Kenya and has been depicted in Figure 1 below. conceptualizes that financial distress factors (Related Transaction Cost) on determinants of financial distress in deposit taking SACCOs in Kenya.

Independent Variables

Dependent Variable

Figure 1: Conceptual Framework

Methodology

Study Area and Target Population

According to Borg and Gall (2009), population is defined as the members of a real or hypothetical set of people, events or objects the researcher wishes to generalize the results of the research. All the licensed SACCOs and those with restricted licenses will be targeted for information by this study. There are 164 licensed SACCOs and 12 SACCOs with restricted license.

Research Design and Sample Size

This study adopted descriptive research design. Descriptive research design was therefore the most appropriate design for this study. Data relating to financial distress determinants in deposit taking SACCOs in Kenya for the current study was collected from the published financial statements of deposit taking SACCOs in Kenya. This was done by extracting, computing the necessary ratios and analyzing all the variables in the study.

The study used sampling formula by Yamane (1967)

$$n = N / 1 + Ne^2$$

Where n = sample size,

N = population size,

e = tolerable error

So the sample size for study based on the Yamane (1967) formula was as follows:

$$n = 176 / 176 * 0.1^2 = 65 \text{ DT SACCOs}$$

The study used systematic random sampling to identify 65 DT SACCOs from the universal population of 176 who were the main respondents to the study.

Data Collection Procedures

The study used data from DT-SACCOs in Kenya published by SASRA annually. This is the body mandated by law in the running of deposit taking SACCOs. Data on the independent variables was collected by use of secondary data, mainly from financial statements between 2008-2014, individual deposit taking SACCOs in Kenya under study. Miles, Huberman and Johnny (2014) characterized information accumulation in research as the way toward social event and estimating data on focused factors in set up methodical style which empowers the interviewee to draft applicable inquiries and decide the normal result. The data collection covered seven (7) year period from 2008 to 2014, this period of seven years was selected for the study in order to establish the changes in deposit taking SACCOs over time and to base the analysis on as recent data as possible.

Data Analysis and Model Specifications

Finally, panel data model was used to test the significance of the influence of the independent variables on the dependent variable. The Zmijewski model was used to develop the Z scores, the dependent variable in the panel data analysis model is as shown below;

Zmijewski Z Score is given by;

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + a_i + u_{it}$$

Where:

Y_{it} = dependent variable (DV), that is Z Scores based on Zmijewski model

X_{it} = independent variables (IV), that is related party transactions (RPT),
 β_1 = coefficient for that IV,
 u_{it} = between entity error term
 ε_{it} = within entity error
 α_i ($i=1, \dots, n$) = unknown intercept for each entity (n entity-specific intercepts)
 i = entity and
 t = time

Zmijewski (1984) used the probit method to predict bankruptcy. The outcome of a probit regression is similar to the outcome of a logit regression between 1 and 0. Most bankruptcy predicting models select the independent variables based on theory, and select the variables with most predictive power. Zmijewski(1984) however, based his selection of independent variables purely on how well the variables predicted in previous models.

Zmijewski (1984) uses the three variables that are most used in previous bankruptcy predicting models, and the model is as follows:
 $Zm = -4.336 - 4.513 X_1 + 5.679X_2 - 0.004X_3$ Where X_1 = net income/total assets, x_2 = total debt/total assets and x_3 = current assets/current liabilities.

A firm with a probability greater than 0.5 is classified as bankrupt and a firm with a probability smaller than 0.5 is classified as non-bankrupt. The overall out-of-sample accuracy rate of Zmijewski's model is 95.29%, but it is important to note that none of the bankrupt firms are predicted to go bankrupt in this classification, and in 99.39% of all non-bankrupt firms the model classified the firms as non-bankrupt. In fact, the cut-off point here is not corrected for the different numbers of bankrupt and non-bankrupt firms. Since for every bankrupt firm, Zmijewski has 20 non-bankrupt firms in his sample, the classification matrix shows that almost all observations are predicted to go bankrupt, since 95% of the total sample consists of non-bankrupt firms.

The interpretation from the coefficients of probit models is not straightforward. For example, if β_2 is the coefficient belonging to variable X_1 is 0.2, if X_1 changes one unit, the Zmijewski-score increases by 0.2. Instead of knowing an increase/decrease in the Zmijewski score, the effect of a change on the probability can also be calculated. To interpret changes of a variable on the probability of going bankrupt, the marginal effect of each variable is needed. The marginal effect indicates how much the probability of bankruptcy changes, when one of the independent variables increases/decreases by one unit, *ceteris paribus*.

Findings and Discussions

The main study objective was to examine the effect of related party transaction on financial distress in savings and credit cooperative organizations in Kenya. Having gone by the random effect model basing on the Hausmann test, the results of the random effect model are presented in Table 1. The analysis shows that the panels were strongly balanced for this bivariate analysis as shown by the number of observations per group.

Hausman Test

In the panel data regression model testing the relationship between related party transaction and probability of distress, fixed effect model and random effect model were fitted and the Hausmann test used to determine the appropriate multivariate model to adopt of the two. The Hausmann specification test results for the multivariate model between financial distresses determinants is shown in Table 1.

Table 1: Hausmann Test

	(b)	(B)	(b-B)	sqrt(diag(V_b-V_B))
	fe	re	Difference	S.E.
RPT	-2.213488	4.305696	-6.519184	3.809207
	b = consistent under Ho and Ha; obtained from xtreg			
B =	inconsistent under Ha, efficient under Ho; obtained from xtreg			
Test: Ho:	difference in coefficients not systematic			
	$\chi^2(1) = (b-B)'[(V_b-V_B)^{-1}](b-B)$			
	2.93			
	Prob> $\chi^2 =$ 0.0870			

The null hypothesis of Hausmann Test is that Random Effects model is preferable and since the results in Table 1 indicate P-value = 0.0870 which is greater than 0.05 confidence level, the null hypothesis is not rejected and hence Random effects model was employed for the analysis of RPT as per Table 1. This implies that the most appropriate model to explain the relationship between financial distress determinants in DT SACCOs in Kenya was the random effects regression model.

Table 2: Regression Analysis of Related Party Transaction and Probability of Financial Distress

Random-effects GLS regression			Number of obs =		476	
Group variable: code			Number of groups =		68	
R-sq: within = 0.1372			Obs per group: min =		7	
between = 0.7005			avg =		7	
overall = 0.3989			max =		7	
			Wald chi2(1) =		200.51	
corr(u_i, X) = 0 (assumed)			Prob> chi2 =		0.000	
firm_dist	Coef.	Std. Err.	z	P>z	[95% Conf. Interval]	
RPT	69.1696	4.884774	14.16	0.000	60.000	78.743
_cons	.222	.158	1.41	0.1600	-.088	0.531
sigma_u .767						
sigma_e 1.962						

There were a total of 476 observations used in this analysis considering 68 groups of entities implying strongly balance panels. The minimum, maximum and average numbers of observations per groups were all equal to 7. The overall R^2 was 0.3989 indicating that 40% of the variance of SACCOs financial distress is explained by Related Parties Transaction (RPT) compared to 60% which were explained by other factors outside the current study. The study established a statistically significant relationship between Related Parties Transaction (RPT) and SACCOs financial distress ($r=69.170$, $p=.000$) as per Table 2.

The F value for accrual quality was significant ($F(1, 474) = 314.56$, $p=0.000$). This implies that there is a significant effect of RPT on financial distress of DT-SACCOs in Kenya. RPT therefore could be used to predict the financial distress of DT-SACCOs in Kenya. This finding indicated that an increase in the RPT by 1 unit will lead to increase in financial distress of DT-SACCOs in Kenya by 69.17 multiple units. This implies that RPT was a predictor of the financial distress of DT-SACCOs in Kenya. This finding is supported by the fact that controlling shareholders resort to prejudicial RPTs for private benefit at the cost of minority shareholders (Peng, Wei and Yang 2011). Prejudicial RPTs are found to erode firm value (Peng et al. 2011) and many of the notorious corporate collapses in the early twenty-first century are associated with prejudicial RPTs (Ge, Drury, Fortin, Liu and Tsang 2010).

In terms of reduction of value, the finding is supported by Berkman, Cole & Fu (2010); Kang et al. (2014); Wan & Wong (2015) who equally found out that the total number of RPTs and find that it has negative relationship with industry adjusted returns. As far as imbalanced distribution of returns on shareholders' investment, the finding is supported by Berkman, Cole and Fu (2010) who established that during the year before the new regulations to protect minority shareholders were implemented, minority shareholders of the firms with higher total value of RPTs have higher abnormal returns compared to those with lower total value of RPTs. Kang et al. (2014) further found that control ownership has positive association with total amount of RPTs and total amount of RPTs have negative impact on firm performance measured with Tobin's Q. Similarly, Wan and Wong (2015) find that RPTs have negative impact on firm performance.

In the further support of the finding, RPTs in total amount (Wan & Wong 2015) are also found to have negative effect on ROA. When Chen, Y, Chen and Chen (2009) separate the control relationship into three conditions: no control relationship, listed firm is the controlling party and listed firm is controlled by related party, RPTs sales are found to have significant negative influence on firm performance measured with ROA in the third condition. When one year ahead or future ROA is used to measure the future firm performance, inter-corporate loan and loan guarantees to controlling owner (Chauhan et al., 2016) and abnormal RPTs net credit (Habib et al., 2017) are found to have negative influence on future firm performance.

Implications

With a substantial number of SACCOs in distress or exhibiting potential of falling into financial distress, a call for stronger policy framework should take precedence in securing the future of the sector. Based on the current findings and the need for the existing SACCO regulatory framework to ensure enhanced savings mobilization, wealth creation and at the same time guaranteed safety of member deposits, the following policy recommendations are worth consideration. First, from the current evidence indicating the important related party transactional cost as a determinant of financial distress, the need for an efficient money market for SACCOs becomes a necessity rather than a choice. While the SACCOs societies Act currently in place intend that SACCOs invests more in government securities as a means of promoting their liquidity, this has not received wider acceptance as indicated by low investment

in government bonds and bills. An assessment of the reasons that has prompted the slow adoption and identification of opportunities for improving access to money markets should be considered.

Conclusions

The study found a significant relationship between related party transactions and financial distress among SACCOs in Kenya. This was contrary to the hypothesized relations of insignificant relationship between related party transactional cost and financial distress of DT-SACCOs in Kenya and therefore, the researcher rejected the null hypothesis H01 that related party transactions has no significant effect on financial distress in Savings And Credit Cooperative Organizations in Kenya. Literally, the current findings indicate that the proportion of core capital to the total assets held by a SACCOs does indicate the likelihood of financial distress. This consequently indicates that capital regulation in the SACCO sector has direct influence on the desired stability in the SACCOs Sector. The finding therefore supports the expansion of Agency Theory. Further study should be conducted among commercial banks regulated by the various Central Banks to ascertain with similar situation we established in this study exist. This is because our study was limited to SACCOs regulated by SASRA.

SACCOs movement has taken root in Kenya right from saving mobilized finances to deposit taking. The current study based on panel data analysis statistically proved that party transactions is key variables which are related with the SACCOs financial distress in Kenya. The study contributes to wide body of knowledge in finance, accounting and corporate governance. Scholars in these areas should use the basis of the findings to carry out further research that can inform strategies within the knowledge domain to reduce the SACCOs financial distress. The current study analyzed a period that predominantly a transition phases for the SACCO sector into a new regulatory framework. Future studies may focus on post regulatory period and bring to the fore that likely predictors in the context of a stable operating environment

Based on the findings, apart from SASRA policy on related party transactions DT_SACCOs in Kenya should ensure that the set policies on related party transactions is implemented to safeguard members' savings and also to ensure that the DT_SACCOs are stable and the mobilized finances are protected for the members' prosperity.

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