

Examining related-party transactions and corporate fraud



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Related parties represent a link where one party can exercise control (direct or indirect) or significant influence over the operating policies of the other party. According to FRS 8 and IAS 24, a related party includes an entity's subsidiaries, associates, joint venture interests, directors and family members of directors.

Related-party transactions are legitimate activities and serve practical purposes such as:

They are recognised in corporate and taxation laws.

They have their own standards for accounting treatment.

Systems of checks and balances have been built around them to make sure they are conducted within these boundaries.

The following parties are not considered as related parties in IAS 24:

Parties which have normal dealing with an entity. Examples include providers of finance, trade unions, government agencies and public utilities.

Parties such as customers, suppliers, distributors and franchisors on which the entity is economically dependent.

Two venturers sharing joint control over a joint venture.

Two entities having a common directors or other member of key management personnel are not considered as related parties.

Related Party Transactions

Related party transactions (RPTs) are defined in IAS 24 as any transactions made between the related parties irrespective of whether a price is charged or not. The transactions include transfer of resources, services or obligations. In other words, RPTs are transactions between a company and its management, board members, principal owners, or members of the immediate families of any of these groups. Examples of RPTs under IASB include rendering or receiving of services, purchase or sales of goods, leases, provisions of guarantees or collateral, purchase or sale of property and other assets, among others.

Moreover, FASB (1982) states that RPTs include transactions between a company and its affiliates. Affiliates refer to entities which control the company, they are controlled by the company or they are controlled by another entity which also controls the company. Examples of RPTs under FASB include services received or furnished, borrowings and lendings, guarantees among others.

Scenarios under related party transactions

When an individual purchases a stock, bond, note or mutual fund from a family member or related party entity, he becomes entitled to the related party rules and under these rules, the individual's cost basis will actually depend on whether he ends up selling it at a gain or a loss.

For example, the individual's sister owned stock of XYZ Corp which she bought for \$20, 000. It had declined in value to \$10, 000 when he bought it

from her. Therefore, she is not allowed to claim a capital loss when she sells it to him because he is a related party.

Gain scenario:

If later the individual sells the stock to a third, unrelated party for \$22, 000, he will experience a true gain of \$12, 000 on his own acquisition cost of \$10, 000. However, he only have to declare a capital gain of \$2, 000 for income tax purposes because he is allowed to use a carryover basis from his sister, since she was not able to claim the previous disallowed loss.

Loss scenario:

If the individual sells it later to a third, unrelated party for \$8, 000, he will have a true loss of \$2, 000 on his own acquisition cost of \$10, 000, and he can only declare a capital loss of \$2, 000 for income tax purposes. However, he is not allowed to use a carryover basis from his sister, even though she was not able to claim the previous disallowed loss. The tax savings from the previous disallowed capital loss are wasted and no one claimed them.

Disclosure

The objective of IAS 24 is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

The IAS 28 requires the following to be disclosed:

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Relationship between parents and subsidiaries: The entity should disclose the name of its parent company or of its ultimate controlling party irrespective of whether there have been any transactions occurred between them. In the case where neither the parent company nor the ultimate controlling company produces financial statement for public use, then the next most senior parent that does so must also be disclosed.

Management Compensation: The compensation of the key management personnel must be disclosed in total and for each of the following categories:

Short-term employment benefits

Post-employment benefits

Other longer benefits

Termination benefits, and

Equity Compensation benefits.

Related Party Transaction: If transactions have been made between the related party, then for each categories of the related party, the following should be disclosed separately:

The amount of the transactions

The amount of the outstanding balances including terms and conditions and guarantees

Provisions for doubtful debts related to the amount of outstanding balances

Expenses recognised during the period in respect of bad or doubtful debts due from related parties.

Types of RPT that lead to corporate frauds

Many high profile companies have made an abuse use of related party transactions to succeed in involving in fraudulent activities. These include companies such as Enron, Adelphia, Tyco and others.

Sales to (or purchases from) related parties of goods and services

According to Pesaru (2002), a related-party sales transaction represents the link between the company and the customer. In this particular transaction, it is usually difficult to identify the related parties. Thus, companies use this technique for boosting revenue. As such, the undisclosed related-party transactions may be used to fraudulently inflate earnings. Companies use “ accounting trick” to mislead the users of financial statements. Presenting a series of sales, which are executed with an undisclosed related-party and which are insignificant is an example of accounting trick used by companies. Moreover, sales made to related party transactions can also lead to corporate frauds if the sales transactions are categorized under fictitious sales. Fictitious sales include round-trip sales. SEC 2003 defines round trip sales as “ simultaneous pre-arranged sales transactions often of the same product in order to create a false impression of justifying those fictitious sales transactions of falling under the normal ordinary course of the business”. This type of transactions inflates sales figures and thus leads to overstatement of revenues.

On the other hand, the purchase of goods or services from related parties is another type of RPT. This type of RPT may lead to fraud when the purchases are not disclosed or when they are considered as unauthorised transactions. Companies create fictitious purchases of services from related party to conceal a misappropriation. For instance, in the Tyco case, it was found that the company failed to disclose a finder's fee paid to an outside director in connection with an acquisition. Besides, one of the principal owners of PNF Industries, Inc. created fictitious records to conceal a misappropriation by claiming that he was owed consultation fees. Since the payments were considered as unauthorised, he falsified a minutes of a directors' meeting to authorize the fees. Non-reported purchases from a related party understate expenses and the effect of the understated figure of expenses is reflected in an overstated sales figure. On the contrary, non-reported revenues and fictitious purchases lead to understatement of income. This whole scenario is summarised in the following diagram.

First scenario: Effect:

FICTITIOUS

SALES

OVERSTATEMENT

OF REVENUES

SMOOTHING INCOME

NON-REPORTED PURCHASES

Second scenario:

NON-REPORTED REVENUE

FICTITIOUS PURCHASES

UNDERSTATEMENT OF INCOME

Genuine sales can be made to the related party in such a way that this transaction transfer wealth to the related party. This can be done if genuine sales are made below its market price to the related party. Another way of transferring wealth to the related party would be unnecessary purchases of goods and services or even purchases above its market price by the company. The other side of the coin will be transferring wealth from the related parties to the company. This is possible when actual sales are transacted to related party at above market prices or when purchases are made below market prices from the related party.

The situation of genuine sales being transacted in a manipulating way can have two impacts:

Firstly, if the company is already facing a crisis in terms of low profits for instance, then the latter can opt for transferring wealth from the related party to itself.

And, if the company is transferring its wealth to the related party, this will lead to misappropriation of company's assets.

Both of these impacts will lead to fraudulent financial reporting. To better understand the picture, a diagram is illustrated below:

Scenario of sales:

GENUINE SALES

Made to related parties under market prices

Made to the company over market prices

LEADS TO TRANSFER OF WEALTH

To the company

To related parties

Scenario of Purchases:

PURCHASES MADE TO

Related parties over market prices

The company from related parties under market prices

LEADS TO TRANSFER OF WEALTH

To the company

An example of a company which uses this to involve in fraudulent activity is Livent Inc., Humatech Inc. and Enron. Livent Inc has mischaracterised certain receipts as revenue. In fact, the receipts were actually borrowings since there were side agreements obligating the company to repay the funds. The counterparty companies were related parties since the top executive of

Livent Inc were a member of their boards. In the case of Humatech Inc, the CEO and the CFO secretly controlled the improper recognition of revenue which was actually sale to a foreign distributor. Indeed, the foreign distributor was a related party but however no disclosure has been made of the transactions. Furthermore, Enron has made a payment to one of its employees of around \$ 10 million and the CFO took it as a SPE. The employee then via a payment to the CFO's family members, share a portion of its fees to the CFO.

Loans to and from the related parties

The provision of loan to and from the related parties is another major type of RPT.

Lack of transparency involved in recording the following transactions outlined below of a company leads to understatement of its liabilities:

Non- recognition of borrowings by the company to the related parties

Non-disclosure of obligations incurred for the related parties in terms of guarantee

Disclosure of loan transactions to related parties

If loans are given to the related parties by the entity are reported accordingly in the financial records of that firm, the issue that arises is in terms of the collateral which is used as a medium to get the finance. In fact, what usually happens is that in case of related party transactions companies tend to overstate the value of these collaterals.

Manipulating interest rates

Wealth are transferred to related party by either borrowing from a related party at above-market interest rates, or lending to a related party at below-market interest rates. If the related parties borrow from the company at an interest rate which is above the market interest rate, this leads to a transfer of wealth to the company. Similarly, if the company is financed out by the related parties at below-market rates or off-market, this would again leads to a transfer of wealth from the related parties to the company. According to Freidman et al. (2003), this kind of practice is referred to as “ propping”. On the other hand, if the company lends the related parties at an interest rate which is lower or even off the market interest rate, this will lead to a transfer of wealth from the company to the related parties.

The scenario of manipulating interest rate can be easily understood through the diagram below:

Scenario: transfer of wealth to the company:

COMPANY

Borrows from the related parties at a lower market interest rate

Lends to related parties at a higher market interest rate

Leads to transfer of wealth to the company

If borrowings from a related party are not recognised, this will result in an understatement of liabilities. Moreover, over-estimating the collectability of loans to a related party leads to an overvaluation of assets. These situations

are known as loan related misstatements and this may eventually leads to frauds. Several companies adopted this technique when preparing their financial statements. For example, Adelphia understated its liabilities by \$1.6 billion. It failed to report its obligation under the credit facility by claiming that its obligation was merely a guarantee which did not require disclosure. In addition to this, Adelphia has netted \$ 1.351 billion related party receivables with against related party payables, which has enable them to hide \$ 1.348 billion of related party payables. The netting has also allowed them to hide the amount of transactions between the Adelphia and the company owned by Rigas family which was Adelphia's controlling shareholders and management team. Indeed, the SEC has stated that the Rigas family has illegally excluded " over \$2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia's off balance sheet, unconsolidated affiliates" and created " sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities." Moreover, PrintontheNet. com did not disclose that it had guaranteed \$7.3 million in related parties' loans. In the case of Tyco, Mr Kozlowski, who was the former Chief Executive Officer of Tyco International borrowed \$ 242 Million from a Tyco program, with the intension to facilitate the executives to pay taxes on restricted-stock grants. However, instead of utilising the funds for that purpose, he spent the finances on yachts, fine art, estate jewelry and luxury apartments. In the same way, Mr Swartz, Tyco's former Chief Financial Officer took a loan of \$72 Million from program and made personal investment and business ventures with that money. In the Enron case, Mahonia, a special purpose entity (SPE) which was <https://assignbuster.com/examining-related-party-transactions-and-corporate-fraud/>

controlled by a financial institution was employed to make some of the Enron's transactions disguised a borrowing of \$ 2. 6 billion from the financial institution as forwards contract. Hence, as a result of the disguised loans, cash flowed from the financial institution to Mahonia and then from Mahonia to Enron.

Investment in related parties

It is crucial to disclose investments in related parties in order to prevent frauds from occurring. Managers tend to manipulate earnings via tunneling actions in order to maintain the company's stock performance. As a result, investment decisions would be expropriated if such decisions are determined based on the financial disclosure. If investment in the equity of a related party is not reported correctly, this will lead to an overstatement of assets and hence will mislead investors about insider activity. Several companies had inflated their assets with RPTs. For example, an investment of \$2. 5 million in a venture capital fund by Hollinger was not disclosed. Moreover, in the Enron case, using the special purpose entities (SPEs) the managers was able to hide unfavourable performance of their investment decisions. Tonka is another example of a company which involve in fraudulent activities. The CFO of the company secretly owned a company and he misappropriate assets of Tonka by making the corporate funds to be improperly been invested in his company.

Hence, it can be seen that many companies has misused related party transaction to involve in fraudulent activities. However, the Sarbanes Oxley Act 2002 has prohibited only one type of related party transaction which was loans to related parties. Indeed, in a study by Henri et al. (2007) which <https://assignbuster.com/examining-related-party-transactions-and-corporate-fraud/>

examined 83 SEC enforcement actions involving in related party transaction and fraud, it was found that the most frequent type of related party transaction was loan to related party.

RPT: A cause for concern

Many accounting frauds such as Enron, Adelphia, Tyco, Refco, Hollinger, Rite Aid have occurred during the past years and have shown concern towards related party transactions. This is because in one way or the other, related party transactions were involved, creating concern among regulators and other market participants about the appropriate monitoring and auditing of these transactions.

However it has been pointed out that research has provided a mixed picture of the role of related party transactions in fraudulent financial reporting. For example, research has shown that related party transaction disclosures are quite common (Gordon et al. 2004a; Wall Street Journal 2003). However, since fraudulent financial reporting is relatively uncommon (Lev 2003), and furthermore most frauds² apparently do not involve related party transactions (Shapiro 1984; Bonner et al. 1988; SEC 2003), it is reasonable to assume that most disclosed related party transactions are not fraudulent.

According to Gordon et al. (2004), RPTs play a fundamental role in a firm's corporate governance environment. It is said that RPTs are an aspect of corporate governance because these transactions are complex issues between a company and its managers, directors, subsidiaries and major shareholders. RPT is considered as an issue to corporate governance because of the problems of asymmetric information between the firm's

manager and external capital markets. Additionally, RPTs result in higher agency costs. This is due to the alignment of decision-making and monitoring rights.

Moreover, according to Johnstone and Bedard (2004), RPTs are difficult to audit and these transactions represent a potential audit risk. When examining the financial statements of companies, auditors do not have adequate information on related party.

Is it fair to blame only bad corporate governance for corporate failures?

Bad corporate governance is one of the reasons which account for the corporate failures. Corporate governance issues, like those with related party transactions, crop up because of the existence of asymmetric information between shareholders and the firm's managers. Existing research has shown that certain board characteristics and CEO pay-performance sensitivity are useful governance mechanisms which help to improve managerial agency problems. For example, large board size, which is observable and disclosed in proxy statements, has been found to be negatively correlated with firm value and interpreted as indicative of weak corporate governance (Yermack, 1996).

However, this does not conclude that corporate failures arise only because of bad corporate governance. There are multitude reasons behind the corporate scandal. For instance, it has been seen that a lack of regulations is one of the reasons. It is believed that the erosion of accounting practices begun in the 1980s as firms tried to balance strict standards with a desire to

please clients and increase consulting business. Research has shown that a lack of government regulation was one of the major causes of the huge energy trading firm Enron. This firm reported profits of hundreds of millions of dollars (\$979 million in 2000, alone) before collapsing in 2001.

Other examples include poor management structures, lack of independence and objectivity by auditors as well as poor business ethics. Ethics can be defined as moral philosophy. It is basically “ the discipline concerned with what is morally good and bad, right and wrong. The term is also applied to any system or theory of moral values or principles” (Ethics, Encyclopedia Britannica Online, 2000). However, when this term is applied in the business context, it is said to be “ the study and evaluation of decision making by businesses according to moral concepts and judgments” (Business Ethics, The Columbia Encyclopedia, 2007).

For instance, in the Enron case, the auditors applied reckless standards to do their audit because they were receiving significant consultation fees from the company.