A Literature Review of Accounting and Auditing Related Parties Tranzactions

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The purpose of this paper is to investigate the scientific literature regarding the nature, extent and consequences of related-party transactions. According to IAS 24 related party transaction represent a a transfer of resources or obligations between related parties, regardless of whether or not a market price is charged. Two entities are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions, for example a controlling shareholder, a director, key management personnel, or affiliated companies, controlled entities, and entities under common control.

Keywords: related party, auditing, accounting, performance, transfer pricing

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Introduction

Transactions conducted between related parties represent a very important issue of the global economy. Also the information concerning related parties transaction occupies an important place in the annual financial reports.

In the academic literature two main definitions are used for related party transaction. The first is that related party transactions are generically defined as transactions between a company and related entities (subsidiaries, affiliates, owners, managers). A second definition is that related party transaction are transactions between a company and an insider who is a person considered to be part of the company.

The common element is the relationship between parties that can influence and establish the binding conditions of the contract (implicitly or explicitly), that are different because the parties are not independent.

One of the most influential and widespread definitions is provided by IAS 24 which define related party transaction as a"transfer of resources, service or obligations between a reporting entity and a related party, regardless of whether a price is charged"(IAS 24). A a related party is a person or entity that is related to the entity that is preparing its financial statements"(IAS 24). Two or more parties are considered to be related, both companies and people, when one of them has the ability to influence the other in making operational or financial decisions. Furthermore, the accounting standard which offers guidance on how related parties information should be structured and presented. There is also an audit standard – ISA 550 „Related parts" which deals with the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements.

We see a lot of interest of international regulatory bodies on audit and accounting in transaction with related parts.

The interest for the subject is determined by the currently conditions and significant changes in the economic policies applied until recently. In such context, related parties transactions and transfer pricing used for this transactions become a favorite target for tax authorities.

The latest major accounting fraud were built in a considerable extent on account of related party transactions, raising concern supervisory and regulatory bodies, and other market users, in connection with ongoing monitoring and audit of these transactions. The complexity and pace of business and capital structure more sophisticated promoted party transactions in the category of ordinary transactions, which have not entered initial concern within the accounting profession. Only as a consequence of approaches "creative" transactions with related parties whose joinder with accounting fraud was the subject of revelations in the last two decades, there has been a change of attitude towards this subject.

In a globalized economy, multinational companies are expanding their activities in more and more countries around the world (Bronson, Johnson, & Sullivan, 2010) . In this context related party transactions are a normal feature of business, because many companies often carry on their activities through subsidiaries, joint-ventures, associates or affiliates. It is estimated that two out of three of all business transactions take place between related parties (European Commision, 2011)

A key concern about related party transactions is that they might not be undertaken at market prices but can be influenced by the relationship between the two sides of a transaction, namely the company and the related party. For example, the transactions may be conducted using favourable prices or terms and conditions, instead of using market prices or normal commercial terms and conditions.

Theoretical background of related party transaction – theories and motives

The issue of related party transaction started to receive attention after the famous financial scandals from the beginning of the millennium, like Enron and Parmalat. In this context, related party transactions emerged as a powerful instrument of financial frauds, shareholders' expropriation, etc., turning the veil from the many relevant loopholes affecting existing requirements (Pizzo, 2013).

In the academic literature regarding related parties transactions, two theories prevail: conflict of interests and efficient transaction hypothesis (Gordon, Henry, Palia, 2004).

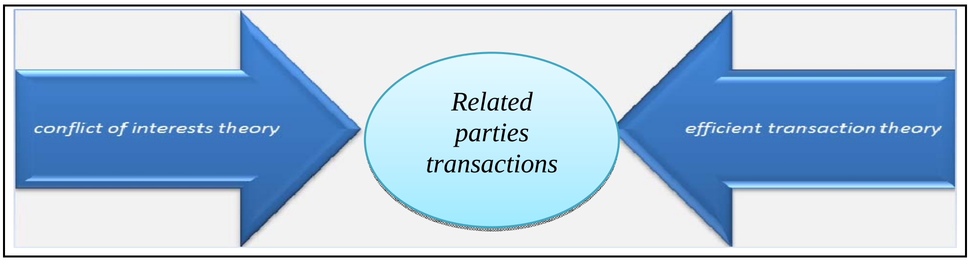

Figure no. 1 – theories afecting the related party transactions

These two different theories provide a general view regarding the potential costs and benefits of related party transactions.

The perspective of conflict of interest is consistent with agency issues of the type considered by Berle and Means (1932) and Jensen and Meckling (1976). According to this theory, related party transactions may imply moral hazard and may be carried out in the interest of directors in order to expropriate wealth from shareholders. Also, this perspective describes related party transactions as potentially harmful to the interests of the shareholders (Gordon, Henry, and Palia 2004; Cheung, Jing, Lu, Rau, Raghavendra and Stouraitis, 2006; Jiang and Yue 2005).

By contrast, the perspective of economic efficiency considers these transactions as normal business exchanges satisfying economic needs of the firm (Pizzo, 2013). The efficient transactions view, which extends the concept of transaction costs developed by Coase (1937) and Williamson (1975), maintains that related party transactions do not harm, and perhaps are even in the benefit of shareholders (Chang and Hong 2000; Khanna and Palepu 2000; Jian and Wong 2010).

But first step is to clarify the notion of related party. Sometimes the notions of participations and related parties are confused and it is not always clear the correlation of terms. On the one hand there may be relationships between two entities such as ownership rights, ability to control or significant influence. Depending on the percentage of ownership and the ability to exercise control, an entity may have subsidiaries, associates and joint-venture entities. On the other the connection between entities can be more diluted but there is still the ability to exert some influence. The notion of related parties captures these situations. So the notion of related parties is a much larger concept and includes also the participations. There are a lot of reasons underlying the development of related party transactions.

These reasons are synthetized in the figure no. 2.

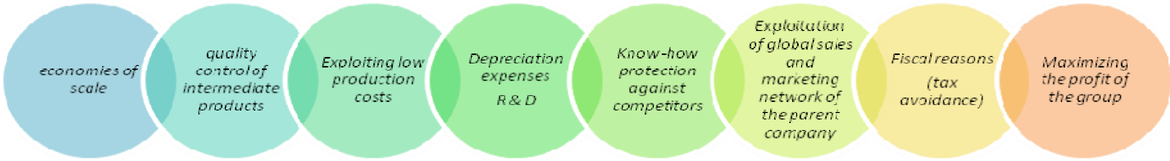

Figure no. 2 - The reasons to intra-group transactions

One important reason for intra-group transaction is possibility to take advantage of specialization and economies of scale. The subsidiaries buy intermediate products in order to process them with their specific technologies. After that, the subsidiary transfers the products to other entities – part of the group dealing with the next stages of the production process until the finished product is obtained. In this way, the whole group can benefits from the advantages of specialization and economies of scale achieved.

Another reason is the fact that intermediate products of the group are significantly safer in terms of quality than products purchased from third parties. The group companies have the ability to place certain operations in countries where the cost of raw materials and labor are low, which brings an advantage. Some group companies make R&D expenditures to develop products or technologies. To exploit the research results, new branches can be created in order to apply these results. By creating new branches the knowhow remains within the group and is protected from any "theft" of the competition.

The group companies have sales network and global marketing activities, benefiting all subsidiaries. In this sense, a company that is part of a group has an advantage over a company operating independently since the first has access to customer network developed by the group, while the independent does not.

The groups have the ability to structure their operations so that activities that bring the biggest profit to be made in countries with low taxation. Profit group as a whole is maximized due to benefits of specialization, economies of scale achieved by placing some activities to countries where costs are low.

Related party transaction in academic research

Related parties transaction is a subject of great interest for academic research. The related party transaction have been analysed in correlation with firm performance, corporate governance, firm valuation, etc. The subject of disclosure related parties transactions is also analysed in correlation with ownership variables, like ownership concentration, in particular tunnelling and propping.

The relation between related party transaction and firm performance has been studied in several countries. In China, Chien and Hsu (2010) have examined the relation between related party transactions and firm performance and the effect of corporate governance mechanism on that relation. They provide empirical evidence that there is a negative relationship between related party transactions and firm performance, a positive relationship between corporate governance mechanisms and firm performance, and a positive moderating effect of corporate governance mechanisms on the relationship between related party transactions and firm performance.

In Italy, Pozzoli and Venuti (2014) examined the relation between related party transaction and company performance in the case of Italian listed companies for the period of 2008-2011. Their findings conclude that related party transactions and companies' financial performance are not correlated and that there is no evidence of a cause-effect relation. Therefore, related party transactions do not appear—thanks also to the existence of control mechanisms a means used by Italian listed companies to realize earnings management, especially earnings smoothing. Also Brava and Melchiorre (2015) have investigated the subject in Italy, but the effectiveness of the disclosure of related party transactions after the introduction of the new rules in Italy. Their results show that although the new rules contribute to increasing the amount of information disclosed to investors, their percentage in relation to the overall amount is serioud low.

Kohlbeck and Mayhew (2010) have examined the stock market valuation of US financial institutions that disclose related party transactions compared to those that do not. Their results suggest that the market assigns lower values to firms that engage in certain types of RP transactions, such as loan between related parties.

Another study of Rahmat (2013) investigated the effect of related party transactions on earnings quality and firm valuation of firms in East Asia. Rahmat finds empirical evidence that related party transactions are significantly associated with discretionary accruals. His findings suggest that firms involved in related party transaction, have significantly lower earnings quality.

Chen and Wu (2010) find that higher ownership concentration speeds up related party transaction.

Cheung et all (2009) examined a sample of related party transactions between Chinese publicly listed firms and their controlling shareholders during 2001–2002. They conclude that minority shareholders in Chinese publicly listed firms that conduct related party transactions with their controlling shareholders are subject to both expropriation through tunneling and gain from propping up from these transactions. Finally, they find that related party transactions representing tunneling are accompanied by significantly less information disclosure compared to related party transaction representing tunneling are accompanied by significantly less information disclosure compared to related party transactions representing propping up party transactions representing propping up. The findings of Chen, Wang and Li suggest that product market competition has a significant positive effect on normal related party transactions. This implies that firms in competitive industries can increase normal related party transactions in order to reduce transaction costs.

Accounting and auditing overview

From the accountant's viewpoint, the general reporting framework for related party-transactions is set out by IAS 24(Corlaciu and Tudor, 2011).

Related party transactions can take a variety of forms. Many of them include transactions in the normal course of business, for example, purchases or sales of goods at market values. However, others can include significant one-off transactions that may be at a fair value on an arm's length basis or that may be at book value or some other amount that differs from market prices. Transactions between entities that are considered related parties must be adequately disclosed in financial statements of the reporting entity. Such disclosures have long been a common feature of financial reporting, and most national accounting standard-setting bodies have imposed similar obligations. In order to ensure transparency, reporting entities are required to disclose the nature, type, and components of transactions with related parties. Another key reason is that an entity needs to disclose related party transactions so that readers are able to understand what part of commercial and other activity is undertaken by the entity and third parties and to what extent the reporting entity is reliant on its related parties.

The stated objective of IAS 24, "Related party disclosures", is to ensure that *"financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties, transactions or outstanding balances with such parties"*. IAS 24 is a disclosure standard. It sets out how related party relationships, transactions and balances should be identified and what disclosures should be made, and when. The standard requires disclosure of related party transactions and balances in the individual financial statements of parent companies and subsidiaries. This means that intragroup transactions between group entities are disclosed, although generally such disclosures are likely to be aggregated by type because of their large volume. For instance, a subsidiary would usually disclose aggregate sales to, and aggregate purchases from, its parent. On consolidation, however, such transactions would be eliminated and would, therefore, not be disclosed in the consolidated financial statements. The standard is also applicable in the case of joint venture or associates.

There are no exemptions from disclosure of intra-group transactions for subsidiaries, or for parent companies that produce consolidated financial statements with their individual financial statements

From the auditor's viewpoint there are two different aspects of related-party transactions which should be considered: *disclosure* and *fraud detection*. Some transactions with related-party might be the result of a bond. Without that bond, the transaction would not have occurred or would have occurred in different terms. Therefore, the disclosure of the nature and amount of transactions with related parties is essential for a proper understanding of the financial statements. Inadequate disclosure of related-party transactions may result in distorted financial statements. For that reason, auditor should be concerned in identifying related party transactions and assessing the disclosure of them.

Related party transactions are difficult to audit for a number of reasons: related parties transactions may be difficult to identify, auditors must rely on management to provide detailed information on related parties and related party transactions, there is a wide variety of parties and types of transactions and some transactions may not be given accounting recognition.

Because of the complexity of accounting and auditing related party transactions, professional auditor must understand and examine them very closely. ISA 550 Related Parties does not allow an individual approach, but a combined one with other auditing standards and / or accounting. It is considered that the most visible standards concerning this issue are: ISA 240 *"The auditor's responsibilities relating to fraud in an audit of financial statements"*, ISA 315 *"Identifying and assessing the risks of material misstatement through understanding the entity and its environment"*, ISA 330 *"The auditor's responses to assessed risks",* ISA 500 *"Audit evidence"*. On the other hand, accounting standards that are directly connected, but not limited, with ISA 550 "Related parties" are: IAS 24, IAS 28, IAS 31.

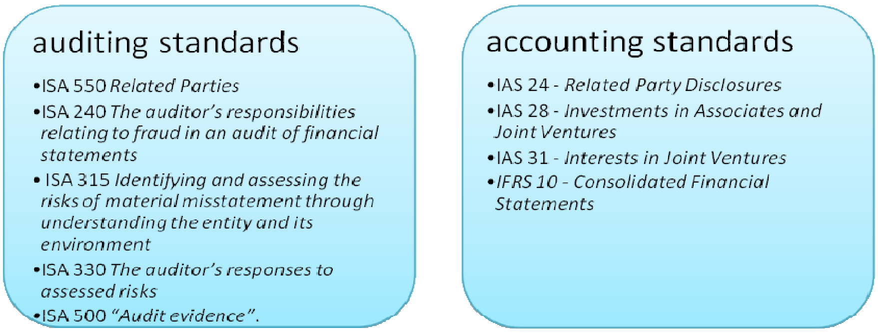

Figure no. 3 – Accounting and auditing framework for related parties transactions

Audit planning involves developing an overall strategy for the expected conduct and scope of the audit. The nature, extent, and timing of planning vary with the size and complexity of the entity, experience with the entity, and knowledge of the entity's business. In planning the audit, the auditor should consider among other matters the conditions that may require extension or modification of audit tests, such as the existence of related party transactions.

Regulation of related party transactions in Romania

The Order no. 222/2008 has introduced the obligation for companies to make a file for transfer pricing (DPT). This order is a more permissive variant of OECD Guidelines applicable in.

The Order provides a two chapters structure of the file: Information about the group and Information about company as taxpayer.

The part regarding the information about the group must contain: organizational structure of the group, legal and operational, including shares, history and financial data relating; general description of the group's activity, business strategy, including changes in the business strategy compared to the previous fiscal year; Description and implementation of transfer pricing methodology application within the group, if applicable; overview of transactions between related parties, the European Union; general description of functions and risks assumed by related parties, including changes in this regard over the previous year; presentation holders of intangible assets of the group (patent, name, know-how etc.) and royalties paid or received; presentation advance pricing agreements entered into by the taxpayer or by other companies within the group about it, except those issued by the National Agency for Fiscal Administration.

The part about the tax-payer must contain: detail of the transactions with affiliated persons, presentation of comparative analysis, presentation of affiliated persons and their permanent establishments involved in these transactions or arrangements; description of the method of calculation of transfer pricing and selection criteria for its argument, description of other conditions considered relevant taxpayer.

Initially, the Romanian legislation has imposed the obligation of making a file of transfer pricing only for those entities that were part of a multinational organization. The starting point was weak, but the desire for transparency and the need for security in a changed economy pushed toward a change. Thus, in July 2011, national regulations extend compulsory documentation on the groups of transfer pricing file.

According to the law, the transaction between related parties must be done at market price, meaning the price at which a transaction would be done similar between independent parties in comparable economic conditions.

Concluding remarks

Related party transactions can be observed through different perspectives, one that puts the risks before the advantages produced by these transactions, and the other which highlights their natural tendency to reduce monitoring costs and information asymmetry.

From a theoretical perspective, related party transactions are studied according to two different perspectives: conflicts of interest and the efficient transaction hypothesis.

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