Related Party Transactions

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Abstract

Related party transactions are a normal feature of business yet it can distort financial reports. IAS 24 prescribes the disclosure requirements for related party transactions. Data from 30 companies shows that the average disclosure compliance index (DCI) is .70. T-test indicates that there is no statistical difference in the DCI means of grouped companies based on auditor type. Correlation and regression analysis show that neither auditor type nor firm size are predictors of DCI.

Introduction

In the course of ordinary business, transactions may be undertaken between related parties. Such transactions are considered usual and normal in today's trade and commerce. As such, many companies are involved in related party transactions. For example, a business may assign part of its operating activities to an investor who has significant influence or control over its financial and operating policies. In this situation, the business and the investor become related parties.

A related party relationship could have an effect on the profit or loss and financial position of a business entity. Related parties may enter into transactions that unrelated parties would not. For instance, an entity that sells goods to its parent company at reduced selling price may not sell on those terms to another customer. Borrowing or lending money at an interest rate that differs significantly from prevailing interest rate may be a result of a related party involvement. It is possible that transactions between related parties may not be made at the same amounts as between unrelated parties.

Now, even if related party transactions do not occur, the financial position and financial performance may still be affected by the mere existence of the relationship between related parties. For example, a company may terminate its business relations with a trading partner because it made a substantial investment in a company that is engaged in the same line of business as the former trading partner. Or a business may also be prohibited from engaging in a particular activity by an investor who has controlling interest in the business. In both cases, the mere existence of a related party relationship wields influence over the activities of a company even without undertaking a business transaction.

For these reasons, IAS 24 is issued by IASB to encourage transparency of the existence of related party relationships and transactions. This international accounting standard provides guidance on the type of information that is material to decision making. Knowledge on this information will give the users of financial reports a better understanding of the prevalence of related party transactions which hopefully will facilitate their informed decisions.

This research aims to investigate the extent of compliance of thirty (30) publicly-listed companies with respect to the disclosure requirements of IAS 24.

Background Literature

The objective of IAS 24 is to ensure the 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.

IAS 24 requires the disclosure of related party relationships where control exists irrespective of whether there have been transactions between the related parties. Relationships between parents and subsidiaries shall be disclosed irrespective of whether there have been transactions between those related parties. For related party transactions where joint control and significant influence exists, disclosure is required if there have been transactions between the related parties. It will disclose the nature of the relationship, information about transactions and outstanding balances necessary for understanding the potential effect of the relationship on the financial reports. In addition, an entity shall disclose key management personnel compensation in total and for each category on short-term employee benefits, post-employment benefits, other long-term benefits and termination benefits.

With the advent of international financial reporting standards, many studies were conducted that investigated the compliance of companies with regards the provisions of the accounting standards. Tsalavoutas and Dionysiou (2011) measured the compliance with all IFRS mandatory disclosure requirements for a sample of firms in a European country. This study showed that the levels of mandatory disclosures are value relevant in terms of net income. High compliance companies have significantly higher net income than that of low compliance companies. Tsalavoutas, Evans and Smith (2008) explored the difference and implication of any difference between two approaches to measuring compliance with mandatory disclosure requirements, namely, the 'dichotomous' approach and the partial compliance (PC) unweighted approach. Under the 'dichotomous' approach, it gave equal weight to the individual items required to be disclosed by all standards. The second approach assumed that each standard was of great importance and gave equal weight to each standard. Using a small sample of Greek companies, their study showed that the two methods produce significantly different overall and relative compliance scores. The study suggested the simultaneous application of both methods to produce more robust findings.

Glaum and Street (2003) examined compliance with both International Accounting Standards (IAS) and United States Generally Accepted Accounting Principles (US GAAP) for 100 German companies. Their study showed that compliance level ranged from100% to 41.6 % with an average of 83.7%. The average compliance level was significantly lower for companies that apply IAS as compared to companies applying US GAAP. The results revealed a considerable extent of non-compliance. The overall level of compliance with IAS and US GAAP disclosures was positively correlated to firms being audited by the big 5 auditing firms and to cross listings on US exchanges.

Kohlbeck and Mayhew (2010) examined that stock market's valuation of firm's that disclose related party (RP) transactions compared to those do not. Using a sample taken from the 2001 S&P 1500, their examination suggested that RP firms have significantly lower valuations and marginally lower subsequent returns that non-RP firms. Market perceptions differed based on partitioning firms by RP transaction type and parties. The results were consistent with the market discounting firms that engage in simple RP transactions.

Chatterjee, Mir and Farooque (2009) investigated the status of related party disclosures of a sample of Indian companies for the financial years 2002- 2006. Using content analysis, the study showed that Indian companies disclosed more than the required minimum level of related party disclosure as required in the Indian accounting standard. They found no association between related party disclosure with market capitalization, industry affiliation and foreign listing for year 2006. But when the scores of all the five years 2002 – 2006 were considered, manufacturing and automotive companies disclosed more about related parties than diversified, service and technology. But an earlier research on Indian companies by Hyderabad (2006) showed poor disclosure compliance on related party transactions. This study analyzed three companies, namely, Reliance Industries, Tata Steel and L&T Ltd. in terms of the extent of dominance of related party transactions. These case analyses revealed that the disclosures on related party transactions were far from satisfactory. The companies did not disclose the terms and conditions of the agreements with the related parties. Further, the amounts of the transactions and the balance due to or due from related parties were not presented. The Indian practices of these 3 companies showed that companies were content to disclose what was expected than to disclose in the interest of the investors.

Hodgdon, Tondkar, Harless and Adhikari (2008) investigated the relationship between analysts' earnings forecast errors and firm compliance with the disclosure requirements of IFRS. Using a comprehensive disclosure index of selected IFRS, the study showed that forecast error is negatively related to IFRS compliance.

It suggested that compliance with disclosure requirements of IFRS reduces information symmetry and enhances the ability of financial analysts to provide more accurate forecasts. It also showed that the extent of compliance with accounting standards is as important as the standards themselves.

Marshall and Heffes (2008) reviewed the 2007 proxy fillings of 350 companies with respect to executive compensation disclosures. They found a number of companies' disclosures wanting. Disclosures focused on details of what is being done but not on the reasons and procedures. They recommended that companies should provide more information on benchmarks and performance targets.

Henry, Gordon, Reed and Louwers (2006) examined 48 SEC enforcement actions involving fraud and related party transactions and documented the role of related party transactions in each case. Loans to related parties were the most frequent type of related party transaction, followed by payments to company officers for either unapproved or non-existent services. The relative frequency of disclosed related party transaction combined with the relative infrequency of financial reporting fraud suggested that their co-occurrence was rare.

Based on the above literature, issues on related party transactions and its disclosures are receiving attention. Dalton and Dalton (2006) cited a significant number of companies which routinely report their involvement in such transactions. RateFinancials found 40 percent of S&P 500 firms engaged in related party transactions in 2004. Another research group, the Corporate Library, found 75 percent of industrial firms reported related party transactions. This rate increased in the five years since 2001. Other issues relate to the complexity of the provisions of IAS 24 because of interpretation problems. Because of its qualitative nature, difficulty is encountered in interpreting some of its terms and provisions. This paper attempts to investigate local experience with 30 publicly listed companies regarding this issue.

Framework and Methodology

The new conceptual framework for financial reporting provides four enhancing characteristics that will render the financial statements useful. These are timeliness, verifiability, comparability and completeness. The principle of completeness parallels the concept of adequate disclosure which states that financial reports must contain all pertinent information that will lead to proper analysis, interpretation and informed decision.

Disclosures are listed in a separate report called Notes to Financial Statements. With this document as the primary source of information, 30 publicly listed companies in the Philippines with related party relationships are selected to provide data for this study. The 2010 financial statements are used for this purpose. Three main disclosure requirements are checked, namely, related party relationships, related party transactions and compensation of key management personnel. For related party transactions, compliance check will cover the four items, namely, outstanding balances, terms and conditions, whether secured or unsecured and provision for doubtful accounts and its related expense. For compensation of key management personnel, the minimum disclosure requirements are short-term employee benefits, post-employment benefits, other long-term benefits and termination benefits.

The dichotomous method is used in performing the compliance check where each disclosure requirement is given equal weight. Each required disclosure is given a code of (1) if disclosed, (0) if not disclosed or (NA) if not applicable. A disclosure index (DCI) is then computed for each company by dividing the actual number of disclosures provided by a company by the number of required applicable disclosures. The dichotomous method is used in the researches of Tsalavoutas, Evans and Smith (2008) and Glaum and Street (2003). The names of the external auditors are also gathered where a code of (1) is assigned if the external auditor belongs to the big 4 auditing firms (SGV & Co., Isla Lipana & Co., Manabat Sanagustin & Co., Manabat Delgado Amper & Co.) and (0) for other auditing firms. Likewise, the total amount of total shareholders' equity is also gathered from the statement of financial position to represent firm size.

This study hypothesizes that the disclosure index for related party disclosures is 100%. It also hypothesizes that the external auditor and firm size influences the level of disclosure compliance of business entities. Descriptive statistics is employed such as mean, median, mode and standard deviation. The DCI mean of the big 4 auditing firms is compared and tested against the DCI mean of the other auditing firms using T-test. Correlation analyses are performed to check the relationships between the dependent variable (DCI) and the independent variables (external auditor and firm size). If there are relationships among the variables, regression will be used to determine their association to one another.

Data Presentation and Analysis

Based on SEC classification, five sectors are represented in the 30 companies used in this study. Five (5) companies belong to the Chemicals sector, six (6) from the Construction, Infrastructure and Allied Services sector, six (6) from the Diversified Industries sector, six (6) from the Electricity, Energy, Power and Water sector, and seven (7) from the Food, Beverage and Tobacco sector. Below is the descriptive statistics for the disclosure index (DCI) and for firm size:

Table 1: Descriptive Statistics for 30 Companies

	Mean	Median	Standard Deviation	Min	Max
DCI	0.70	0.71	0.17	0.33	1.00
Firm Size	P7,318,606,130	P2,240,675,574	11,320,382,754	P-505,725,452	P49,362,667,000

The average disclosure index for related party disclosures is .70 with the lowest index posted at .33 and the highest at 1.00. In terms of total shareholders' equity, average firm size is P7.3 billion. Smallest firm size is P-505.7 million representing a capital deficiency while the largest firm size in this dataset is P49.3 billion.

Table 2: DCI per Sector

	Mean	Median	Standard Deviation	Min	Max
Chemicals	0.77	0.71	0.239061	.43	1.00
Construction, Infrastructure and Allied Services	0.66	0.67	0.214818	.33	1.00
Diversified Industries	0.76	0.73	0.134077	.60	1.00
Electricity, Energy, Power and Water	0.74	0.75	0.020656	.71	.75
Food, Beverage and Tobacco	0.58	0.63	0.130475	.43	.75

The Chemicals sector has the highest average DCI posted at .77 followed closely by the Diversified Industries sector at .76. The Food, Beverage and Tobacco sector posted the lowest average DCI computed at .58. Of the thirty (30) companies in the sample group, four (4) companies have a computed DCI of 1.0. Two (2) companies belong to the Chemicals sector, one (1) company from the Construction, Infrastructure and Allied Services sector and one (1) company from the Diversified Industries sector. The lowest DCI is calculated at .33 for a company that belongs to the Construction, Infrastructure and Allied Services sector.

Table 3: Percentage of Compliance per Disclosure Requirement

Disclosure Requirement	Total	Chemicals	Construction, Infrastructure and Allied Services	Diversified Industries	Electricity, Energy, Power and Water	Food, Beverage and Tobacco
Related party relationships	.93	1.00	.80	1.00	1.00	.86
Related party transactions						
Outstanding balances	.88	1.00	1.00	.83	1.00	.57
Terms and conditions	.94	1.00	1.00	.83	1.00	.86
Provision for doubtful accounts	.11	.25	.17	0.00	0.00	,14
Related bad debts expense	.08	.25	.17	0.00	0.00	0.00
Compensation of key management personnel						
Short-term employee benefits	.89	.80	.80	1.00	1.00	.86
Post-employment benefits	.92	.75	1.00	1.00	1.00	.83
Other long-term benefits	1.00	-	-	1.00	1.00	1.00
Termination benefits	1.00	1.00	-	-	-	-

Around 93% of the sample-companies gave proper disclosures regarding their related party relationships. However, only 11% and 8% of the companies disclosed information regarding provision for doubtful accounts and the recognition of the related bad debts expense, respectively. Disclosures on compensation of key management personnel, specifically on other long-term benefits and terminations benefits are few. For instance, all the six (6) companies under the Construction sector has zero disclosures on these compensation benefits.

Table 4: DCI and External Auditor

Type of Auditor	No. of Companies	DCI					
		Mean	Median	Mode	Std. Dev	Min	Max
Top 4	25	0.71	0.71	0.71	0.150693	0.43	1.0
Others	5	0.65	0.71	0.71	0.25229	0.33	1.0

Twenty five (25) out of the thirty (30) companies or 75 % are audited by the top 4 auditing firms in the country. The average DCI of the 25 firms is .71 with a standard deviation of .15. The remaining five companies are audited by other auditing firms. They posted an average DCI of .65 with a standard deviation of .25. The lowest individual DCI of .33 belong to this group of five companies audited by other auditing firms.

Table 5: Test Results of the Mean Difference Based on Auditor Type

	Top 4 Auditing Firms	Other Auditing Firms
Mean	.706000	.650000
Standard Deviation	.150693	.252290
N	25	5
df	28	
Difference	.0560	
t-statistic	.676433	
p-value (two-tailed)	.504315	

Using t-test analysis, results show that the mean difference between the two sample groups of .0560 is not statistically significant. Using an α level of .05, a p-value of .504315 at two-tailed indicates that there is strong evidence to conclude that the mean DCI of companies audited by the top 4 auditing firms is not significantly different from the mean DCI of the companies audited by the other auditing firms.

To determine the existence and strength of relationships among DCI, type of auditor and firm size, Pearson's correlation is performed on the three variables.

Table: 6 Correlation Matrix

	DCI	Type of Auditor	Firm Size
DCI	1.0000	.126802	.057528
Type of Auditor	.126802	1.0000	.128147
Firm Size	.057528	.128147	1.0000

There are no marked correlations among the three variables that are significant at $p < .05000$. Pearson correlation shows that there is sufficient evidence to conclude that there are no relationships among DCI, auditor type and firm size.

Table: 7 Regression Analysis

N=30	Regression for Dependent Variable: DCI R = .19043329 R^2 = .03626484 Adjusted R^2 = -0.0749353715 F(3,26) = .32612 p < .80645 Std. Error of estimate = .17356					
	b*	Std. Err. of b*	b	Std Err. of b	T(26)	p-value
Intercept			.642104	.078881	8.140142	0.0000
Auditor	0.138702	0.195666	0.061255	0.086413	0.708871	0.484712
Firm Size	0.379456	0.516203	0.000000	0.000000	0.735091	0.468863

When DCI is regressed against auditor type and firm size, R^2 is computed at .036. This shows that only 3.6% of the behaviour of DCI can be explained by both auditor type and firm size. Since the F-value is more than .05, it is concluded that the above regression model is not statistically significant. This analysis shows that auditor type and firm size are not influencing factors of DCI.

Conclusions and Implications

Based on the analysis of the above data, the following conclusions are made. The average DCI of the 30 companies in this study is .70 which indicates that there is deficiency in the compliance of disclosure requirements per IAS 24. In terms of content, disclosures on doubtful accounts, other long term benefits and termination benefits are generally lacking. Using t-test, this study also shows that there is no statistical evidence to prove that the DCI of companies audited by the top 4 auditing firms are not the same as the DCI of companies audited by the other auditing firms. This study does not prove that if a company is audited by any of the top 4 auditing firms, DCI will be higher than if audited by other auditing firms. Furthermore, correlation analysis shows that there are no relationships among DCI, auditor type and firm size. Regression analysis validates this finding by showing that auditor type and firm size are not influencing factors of DCI.

As seen from the above discussion, compliance to the disclosure requirements on related party transactions need full implementation by business entities. SEC should closely monitor and compel companies to implement all the provisions of IAS 24. Failure to disclose related party relationships as well as its transactions breaches good corporate governance. Without this relevant information, the financial reports will not be able to alert its users that the financial position and performance of a business may have been affected by the existence of related party relationships and transactions. SEC should impose enough sanction and penalties to erring companies to discourage them from doing this again. Academe should put forth a strong statement to their students that the only way to achieve fair presentation of financial reports is the full application of international accounting standards.

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