Related Parties' Transactions: A Literature Overview on Auditor's Risk

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Abstract

The aim of this paper is to examine the nature of related party transactions, how they are reflected in the context of a financial audit and the challenges of resolving risk management issues, detecting fraud and the effects of coordinating these transactions by company management between two or more affiliated companies. To achieve the objective, the research methodology is qualitative and is based on the selection of a sample of relevant articles from journals indexed in the international database in which the risks identified in transactions with related parties were highlighted. The research results show the main risks identified were fraud risk, risk of misstatements and the company value manipulation risk. In conclusion, it can be stated that there are additional factors in the audit of related party transactions that the auditor must take into account so that there is no impact on the correctness and accuracy of the results of the final audit report.

Key words: transactions, related parties, auditor, risk, transfer pricing
J.E.L. classification: M42, M48, K34, F23

1. Introduction

With the increasing number of multinationals companies (MNC), the number of related party transactions also increased, enabling groups of companies to move profits in jurisdictions which are more relaxed in terms of taxation. This situation poses a high risk to the governments of all countries, as their tax revenues could be reduced. With this in mind, more and more countries are adopting and expanding their transfer pricing legislation to prevent the erosion of the tax base and the shift of profits between multinational companies.

In Romania, in accordance with the provisions of the Fiscal Code, transactions between affiliated persons are important to respect the principle of the free market. Adherence to the principle of arm length is, according to transfer pricing legislation, the essential decision-maker regarding pricing. The Fiscal Code doesn't differentiate between transactions performed between an affiliate Romanian company and transactions between a resident affiliate and a non-resident affiliate company.

The auditor must identify and evaluate the risks of significant misstatement associated with relationships and transactions with related parties and determine if any of those risks are significant. When the auditor establishes this, he must consider the significant transactions with the affiliate party which is outside the legal regulations as the source of significant risks.

Most international transactions are conducted by and within the concern. Transfer prices have benefited from increasing interest in recent years because: i) It is allowed to move certain service activities to centers that combine all members of the international company that are located in a certain geographical area; ii) International commercial activities can be carried out without interruption due to the development of electronic commerce allowed by the new IT techniques. Specific intra-group reporting requirements have been established at the level of the framework regulations for (in this case) financial reporting and where there are no such requirements the auditor is responsible for performing specific procedures with the purpose of discovering, analyzing and responding to misstatement risks, as a consequence of the failure of the entity in adequately presenting the intra-group relations and/or operations.

The objective of the paper is to synthesize theoretical information on auditors' risks related to related party transactions and to identify the main risks studied by other researchers in the last five years. To achieve the objective of the paper, the research methodology is qualitative and is based on the selection of a sample of relevant articles from journals indexed in international databases.

The paper contributes to the literature by reviewing previous research on the risks identified in related party transactions, as well as determining their impact on the performance of companies. The practical implications of the paper are addressed on the one hand to investors who could determine whether transactions with related parties are beneficial to their companies and what categories of risks they must assume by choosing one branch of activity or another. On the other hand, regulators may consider additional disclosure requirements regarding the characteristics of the business in order for those related parties to improve their understanding of the nature, risks and liabilities behind the disclosed related party transactions.

The paper contains a review of the main concepts and relevant literature in the related party transactions area; the research methodology has been focused at studying the most relevant scientific articles on this topic and their findings. The major associated risks were identified and indicated in the present study and the conclusions are presented in the last part of the document.

2. Literature review

Anghelache (2017) considers that among the users of financial statements, those who prepare them and consultants, there is a growing opinion that risk reporting needs to be further optimized; the more accurate the risk reporting, the better the administrative direction. What needs to be determined is the balance between what investors and users would like to see, and what organizations want to disclose. In particular, organizations are inflexible in revealing any aspect that could affect their position vis-à-vis competition or in detailing the risks they anticipate, to the extent that this would bring panic to those concerned, in particular for financiers. Unfortunately, the result is usually a cliché report, which presents only generic risks and does not bring any real benefit.

As indicated by Jorgensen and Morley (2017), the impact of transactions with related parties may vary depending on the country, with different degrees of capital market development, regulatory environment and characteristics of company ownership, etc. In this respect, the arguments of related party transactions based on transaction costs are probably more applicable to the Eastern European market than to markets in developed countries with mature stock markets.

Lately, both in terms of regulating financial audit activities and in terms of financial accounting, there is still a general emphasis on the confidence that users can have in the reports published by companies on financial statements. In this respect, the respective shareholders and other interested parties need accurate, complete and easily accessible information. This trust depends both on the accuracy and degree of involvement of those responsible for preparing those financial statements but also on the degree of independence and level of objectivity of the opinion of the financial auditors in the audit process. In this way, the responsibility for the correct, transparent presentation which is also adapted to the real economic situation of the information contained in the financial statements rests both with the management of the company that presents this information and with the financial auditors who express their opinion on them.

As a result, both at European and national level, the interest in highlighting the most transparent financial information presented leads to the need to have increasingly strict regulations regarding the reporting of transactions between the company and affiliates, the presentation of off-balance sheet commitments and the need to introduce a statement on corporate governance. Despite the fact that recent literature has begun to distinguish between the types of "good" and "bad" transactions, the relevant evidence is still quite diverse in terms of related party transactions. Aharony et al. (2010) consider that sales of related parties are driven by exploitation, while Habib et al. (2015) and Kohlbeck and Mayhew (2017) support the vision of more efficient contracting for sales or purchases between related parties. Wang et al. (2019) tried to identify a potential moderator, as an example of the similarity of the industry between the group's affiliates, which would determine that transactions with associated parties to be a "model of perfection"

The major risk involved in related party transactions is their manipulation in order to reduce the taxable mass and move them to countries with lower taxation or in countries where shareholders have special interests as well as their manipulation to influence the stock market that these companies are listed on. Kohlbeck and Mayhew (2017) consider that the uncontrolled nature of related party transactions facilitates wealth transfers between the firm and related parties, usually to the detriment of minority shareholders.

Internal market transactions between related parties could be particularly beneficial due to the low level of asymmetric information and therefore lower transaction costs. Jorgensen & Morley, (2017). For example, Habib et al. (2015) consider that sales / acquisitions between related parties, i.e. transactions with related parties, fulfill this perspective of efficient contracting of related parties transactions (RPT), thus leading to a decrease in audit fees. In contrast, loans to related parties result in the opposite conclusion, ie higher audit fees. Kohlbeck and Mayhew (2017) separate related party transactions into "tone-related" and "business-related" transactions and find that business (tonal) transactions are associated with a lower (higher) risk of misstatement while transactions "Tunnel-oriented", such as related party loans, are associated with negative consequences, there is still an open question about the impact of "normal" related party transactions, for example, sales / purchases between related parties, due to evidence mixed from the existing literature.

Transfer prices are a neutral phenomenon. Their use or abuse makes it a harmless commercial practice or a conscious offense. The transfer price is not an immoral or illegal act. It can only be for business reasons, without any intentional or unintentional effort to deceive the government or any party involved. Therefore, transfer pricing is generally conceived as an admissible practice, as are other administrative or commercial practices of commercial entities. Therefore, transfer pricing should be treated as a routine practice and not as a tax avoidance tool. Hence, naturally, the importance of accounting regulations under which corporations must provide in a note to the financial statements a summary of related party transactions to emphasize their transparency. Romanian researchers conducted studies on the disclosure of data on relations and transactions between related parties, in the case of companies listed on the Bucharest Stock Exchange (Corlaciu și Tiron-Tudor, 2013; Feleagă și Neacșu, 2016).

Căpățână-Verdeş (2019) hypothesized that disclosure of data in accordance with end-user specifications is the main target of any senior business management wishing to attract investment. Disclosure of related party and transaction data will need to increase end-user confidence in annual tax reports issued by a group of companies. The annual tax reports will contain incorrect data on the health and performance of the business, given the manipulations performed in the reported accounting data. Only the compliance of the data reported in the accounting records and the voluntary disclosure of the data will disclose the business condition of the affiliated entities as true or not. This will increase the transparency of transactions between affiliated and trusted entities in their operational reports.

The involvement of auditors, as is the case in several Member States of the European Union, and of the audit committee is imperative. Auditors must be independent and their duties already include control over related party transactions. Accordingly, the audit tasks may be extended to include reasonable assurance that the expected related party transactions are fair economic transactions. The Audit Committee may serve as the body that approves the transaction with related parties. The auditor may annually provide in his report the results of his assessment of the fairness of transactions with related parties. This procedure is less burdensome and can help mitigate the risks of transferring assets from related party transactions by eliminating the associated risks and taking responsibility.

3. Research methodology

The research methodology is qualitative and consists in synthesizing the relevant scientific papers that had as object of research the topic of transfer pricing and transactions with related parties and that addressed the effect of indicators on their impact on companies. The articles were selected from international databases and included studies conducted at international and national level. The chosen period was 2014-2020, and the selection criterion was according to the keywords: affiliated parties, transfer prices, risk, audit associated with the topic.

4. Findings

From the selection made, a large number of articles were identified, that addressed the topic studied but for greater clarity and accuracy 20 representative articles were analyzed, whose synthesis is grouped in Table 1. In this table for each paper the proposed objectives were selected, also research methodology, the samples on which the study is based, the most significant results and the risks that may be associated with the results of the studies. the articles are ordered in the table starting from the most recently published.

Table no 1: The results of the scientific papers analysis

Authors	Objective	Research methodology	Sample	Results	Risk
Bond &Thomas (2020)	Studies the economic effects of unilateral adoption of corporate tax policies that include the choice between destination-based and source-based taxation and between cash flow and income taxes.	Theoretic model	Two countries hypothetical model with two final goods.	Among other findings, the authors conclude that countries with sizable export markets will prefer income taxation to cash flow taxation and border adjustments are optimal under income taxation.	Fraud risk
Hendratama et al. (2020)	Investigates the influence of related party transactions (RPTs) on firm value.	Multiple regression analysis	274 observations from listed firms in Indonesia	Provides evidence that concerns regarding RPTs being value destroying and value enhancing are warranted	Company value manipulation risk
Ocak et al. (2020)	Examines the association between audit quality and individual auditors providing audit service to firms in the same business group.	Propensity score matching	Sampled Turkish Listed firms traded in Borsa Istanbul between 2010 and 2016	Individual auditors providing audit services to the firms affiliated with the same business group in Big4 audit firms tend to issue a modified audit opinion.	Risk of misstatements
Căpăţână-Verdeş (2019)	To verify how Romanian listed businesses are complying to regulations related to relationships and transactions among related parties.	Qualitative data analysis	Annual Tax Reports on 53 companies listed on Regulated Market in 2016	This study output shows that Romanian listed companies disclose 53% of data on related party transactions	Risk of non-disclosure of data in financial statements

Wang et al. (2019)	Investigates whether business relatedness, i.e., the degree of related diversification within a business	Econometric model	Final sample comprising 20,151 firm-year observations on companies in Taiwan during 1997–2016.	Transacting with a related party in the same industry does increase firm performance	Risk of misstatements
Kim et al. (2018)	Analyzes the trade-offs in the multinational firms optimal choice of supply chain structure.	Econometric model	Theoretical modeling of a multinational company optimal structure	The results suggest that tax considerations deserve attention from managers when designing the supply chain structure.	Fraud risk
Neacsu (2018)	Addressing the issue of transfer pricing from the perspective of the Romanian regulations	Questionnaires analysis	4486 questionnaires	It was concluded that at the level of the Romanian transfer pricing legislation, a reform is needed in multiple areas.	Fraud risk
Wier (2018)	Systematic evidence of profit shifting through transfer mispricing in a developing country.	Regression model	5.000.000 transactions for goods imports 2011-2015 in South Africa	Provides proof that transfer prices are manipulated according to the desired tax level.	Fraud risk
Al-Dhamari et al. (2017)	To date studies on the association between RPTs and audit fees	Regression models	120 listed firms in Malaysia	Evidence of tunneling risk created by related party transactions	Company value manipulation risk
Anghelache (2017)	The author's goal is to explain how the reladed party transaction's risks are divided among the investors, consultants and auditors.	Theoretical model	Personal views based on current practices regarding transfer pricing	The author concludes that the risk reports are usually presented in a stereotypical way which brings no real benefit to the intended recipients. A set of internal controls helps the management with identifying and evaluating risks.	Risk of misstatements
Bona-Sanchez et al. (2017)	Related-party transactions, dominant owners and firm value	Statistic model	94 Spanish companies, 671 firm-year observations for the period 2004-2012	Connected transactions between listed Spanish firms and their block holders account for 99.84% of the total RPTs carried out by listed Spanish firms.	Commercial risk

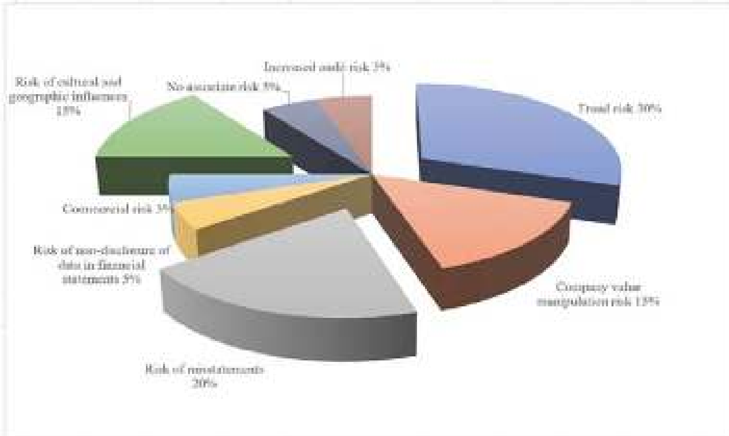
Hussein et al. (2017)	Study ascertains whether cultural affiliation of the negotiator impacts this fairness effect	Questionnaire per email	64 American and 64 Chinese participants in an US university master's program	Cross-cultural differences in the perception of fairness affect transfer price negotiation	Risk of cultural and geographic influences
Ignat et al. (2017)	The objective of the research was to identify the level of strictness for the transfer pricing regulations from the European countries.	Report analysis processed with computational formula	47 countries from Europe in 2015	The results obtained from the analysis performed shows that the strictness of the transfer pricing regulations decreases from the west of the Europe to the east of this continent.	Risk of cultural and geographic influences
Kohlbeck and Mayhew (2017)	Investigates whether or not related party transactions serve as "red flags" that warn of potential financial misstatement.	Empirical-archival methods	3,588 firm-year observations from 2001, 2004, and 2007 - USA	Tone-based RPTs serve as signals of higher risk of material misstatement. Restatements are more likely when a firm engages in related party transactions.	Risk of misstatements
Zheng (2017)	Investigates whether there is a tax avoidance difference between stand-alone companies and diversified companies	Multivariate regression analyses	30,826 firm-year observations from 6057 firms in USA	The conclusion shows that the diversified firms engage in fewer tax avoidance practices than stand-alone firms.	Fraud risk
Rathke et al. (2016)	Analyses the characteristics of transfer pricing systems across countries.	Econometric model	Transfer Pricing Guidelines published by the major audit and tax advisory firms for the year 2014.	The overall TP systems throughout different groups of countries present general similarity but there is no complete homogenity across them, which indicates that some of them are more biased towards profit shifting and tax avoidance behaviour.	Risk of cultural and geographic influences

Gao et al. (2015)	Presents a comprehensive model that aims to determine the optimal transfer price for a MNC to maximize the entire organization's profit.	Mathematic model	A bilinear model was created and sampled using Matlab R2012a.	Division managers should keep a close eye on tax rate fluctuations of the selling/buying counterparts as a decrease in the tax rate might lead to the other party's revenue loss or cost increase.	No associated risk
Habib at al. (2015)	Investigates the effect of related-party transactions on audit fees in China.	Regression models	300,395 related party transaactions sampled, final analysis carried on 8661 transactions in Indonesia	Audit fees are relatively high for RPTs involving loans and capital transfers when listed parents transact with their subsidiaries. Chinese audit market raises doubt about audit quality.	Increased audit risk
Davies et al. (2014)	Intra-firm prices may systema-tically deviate from arm's length prices for two motives: pricing to market and tax avoidance	Empirical model	67,312 firms, 5,482 products and 45 countries	Significant increase in revenues may be achieved at a small cost by targeting reduced tax countries and fiscal heaven countries.	Fraud risk
Kang et al. (2014)	Examines whether RPT are used as a mechanism for tunneling among firms belonging to large business groups in Korea.	Econometric model	982 firm-year data of publicly traded firms in Korea	The control–ownership wedge is positively associated with the nr. of RPTs. RPTs increase as voting rights increase, while RPTs decrease as cash flow rights increase.Also, RPTs occur when the agency problem is severe are used as means of tunneling, thus destroying firm value.	Company value manipulation

Source: own projection

In 2017, Kohlbeck and Mayhew classified related party transactions into two categories, "Tone" transactions and "business" transactions, thus making it easier to identify the risks associated with these transactions. Most works follow this classification model in the analysis performed: business transactions were associated with the following risks: the manipulation of the taxable mass and its transfer to countries with low taxation or tax havens, failure to present financial statements, error and commercial risk due the fact that the affiliates depend in a significant way on a single client (the parent company) and with the Tone transactions the risk of manipulating the value of the listed companies and manipulating the profits for the benefit of the managers, was associated.

Figure no. 1: Risks identified in the analyzed studies



Source: own projection

The analysis reveals that the biggest weight in the identified risks belong to fraud risk, risk of misstatements and the company value manipulation risk (Figure no. 1). This triggers an alert regarding the current regulations applicable to this type of transactions and indicates a critical need for a close tracking of them by the responsible authorities.

Conducting the analysis and implementation of identification and disclosure procedures in financial statements should become a priority for any company conducting significant international transactions. The analysis and compliance process can be a rigorous one, lasting but which can take the company out of a risk area from a fiscal point of view and place it in a correct position of fiscal compliance.

5. Conclusions

Establishing the conceptual framework for audit regulations (which considers related party information to be important to users of financial statements) is very important, as the existence of a certain level of control or influence can have an impact on the terms of transactions between affiliated entities. Also, the identification of the way and conditions in which two affiliated parties perform operations is important for understanding the financial statements of the entity and in this context the conclusions of the papers presented and published may bring things in a more concrete perspective: (1) Extending the analysis by drawing up a target strategy that considers only articles related to related party transactions, responsibilities and risks in financial reporting; (2) Analysis of the conditions in which transactions with affiliated parties improve the performance of companies. While related party transactions are negatively associated with the company's performance and some of the studies analyzed have tried to prove otherwise, namely that these transactions can increase performance by eliminating the risks associated with the industry and taking responsibility for those in charge of governance; (3) Contributes to the literature by providing a better perspective in analyzing the motivations behind related party transactions, determining their impact on firm performance and could help investors determine whether or not affiliated transactions are beneficial to their firms and what risk categories they must consider by choosing one branch of activity or another; (4) Highlighting the level of information regarding transactions with related parties presented in the financial statements by identifying new influencing factors, such as the industry in which the analyzed companies operate, the quality of management; (5) Identification of additional disclosure requirements regarding the characteristics of the business in order for those related parties to improve their understanding of the nature, risks and responsibilities behind disclosed related party transactions.

So far, the existing literature covering this area has tried to explain and define the benefits and also the risks associated with related party transactions and this study aimed to take the research a step further by aggregating the information into a more condensed form.

One of the limitations of this study is given by the fact that the companies in the analyzed sample were large companies listed on the stock exchange or public companies and the conclusions drawn cannot be extrapolated to the rest of the companies that hold such transactions in their portfolio. It would be interesting to open future research avenues that would also include this segment considered probably negligible, but to which the tax authorities in the jurisdictions now turn their attention by introducing a new set of reporting on these types of transactions. It is unanimously accepted that the automatic exchange of information in the field of taxation between EU Member States is essential in achieving the objective of ensuring fair taxation, namely the taxation of profits in the jurisdictions in which the taxable amount is generated. For transactions between affiliates, cross-reporting at the international level and the extension of the exchange of information on transactions with fiscal risk take on other dimensions in terms of content and reporting.

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