U.S. Auditors' Role in Identifying Related Party Transactions

When Conducting Audits of Chinese RTO Issuers

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With respect to the auditing of Chinese RTO issuers, the primary challenge for auditors, particularly U.S.-based auditors, has often been to obtain full information about related party transactions and balances from the client. In conducting business in China, understanding the implications of "guanxi," which means relationship, is crucial. By and large, Chinese business people still prefer to do business with others they know and trust, whether through familial relationships or introductions by mutual or longtime business associates. As a result, there may be Chinese clients who do not fully appreciate the breadth of the definition of related parties, or may actually consider transactions with such parties to be ordinary (i.e., at arm's-length) and routine, and thus not worthy of disclosure. It is the U.S. auditors' task, therefore, to educate the Chinese client regarding both the meaning of the term "related parties," and the disclosure requirements under U.S. GAAP with which it must comply. The financial reporting requirements regarding related parties, as set forth by ASC 850 (codified from SFAS No. 57), are essentially disclosure obligations, not accounting rules.

It has long been held under U.S. GAAP that users of financial statements wish and need to be informed about transactions or balances arising from entities that are not in arm's-length relationships with the reporting entity. This is deemed to be important for a variety of reasons, including the possibility that the terms of the transactions (payment terms, prices, etc.) are not objectively determined, and thus give a distorted view of the reporting entity's "normal" or expected future operating results. The mere existence of related parties, in fact, is often seen as being important information, since it could imply constraints on (or, conversely, opportunities for) future economic activities that would not otherwise exist. Users of the financial statements need to be informed of the fact that, for instance, the Chinese RTO issuer cannot compete in certain provinces in China because its sister company has exclusive rights in that regional market. Even though the Chinese RTO issuer has no transactions with the affiliate (which is also a related party), the fact that it is constrained from entering that market (having carved up the country among its affiliated, commonly controlled sisters) is important information for users trying to project future revenues and cash flows.

For all auditors, the crux of the issue is to fully identify related parties, consistent with the definition set forth by ASC 850. That standard stipulates that related parties be broadly defined to include all of the following:

- An affiliate of the company, i.e., a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with a company. *Control* for purpose of FASB Statement No. 57 means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a company through ownership, by contract, or otherwise.
- Entities for which investments are accounted for by the equity method by the enterprise.
- Principal shareholders of the enterprise, i.e., those owners of record or known beneficial owners of more than 10 percent of the voting interests of the company.
- Management of the enterprise, which includes persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management for purposes of applying this criterion.
- Members of the immediate families of principal shareholders of the enterprise and its management. Immediate family includes family members whom a principal shareholder or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Identifying related party transactions, if these have not otherwise been acknowledged by management, is one of the auditors' more challenging responsibilities. First, transactions with related parties are not always easily identifiable. Second, although other procedures are ordinarily performed, auditors rely primarily upon management to identify all related parties and related party transactions; they typically do little independent testing to identify parties and transactions, unless as part of other auditing procedures patterns become obvious that then raise further questions leading to such revelations. Third, such transactions may not be easily tracked by a company's internal control.

Some of the indicia that may suggest that transactions have taken place with parties that are to be deemed related to the reporting entity include:

- Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction, or when there are no scheduled repayment terms.
- Acquisitions or dispositions made at a price that differs significantly from its appraised or fair market value.
- Exchanging property for similar property in a nonmonetary transaction.
- A highly significant portion of the company's sales concentrated in one or two customers.
- A major customer is severely delinquent even when longer than normal credit terms are being extended.
- Sales without substance, including funding the other party to the transaction so that the sales price (receivable) is nominally being fully remitted.
- Sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue.
- Payments made by a major customer other than for the purchases of goods by that customer or for services never rendered or at inflated prices.
- A key customer that has an unusual business address, such as a residential address, or an incomplete address on record.
- Accruing interest on loans at above or below market rates.
- Loans to parties that do not possess the ability to repay.
- Loans advanced ostensibly for a valid business purpose and later written off as uncollectible.
- Advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable.
- Sales at below market rates to an unnecessary "middle man," who in turn sells to the ultimate customer at a higher price with the intermediary (and ultimately its principals) retaining the difference.

There have been recent allegations made against certain Chinese RTO issuers for failure to disclose material related party transactions. As is true regarding all aspects of the financial statements, disclosures of related parties, and of transactions with them, are fundamentally the responsibility of management. Although management's responsibility, it is the auditors' duty to gain an understanding of the Chinese RTO entity's controls over the financial reporting process, including those elements that govern the identification and disclosure of related party transactions. If control weaknesses are identified, the auditors should perform modified, extended or additional audit procedures as are appropriate in the circumstances. If auditors fail to apply appropriate procedures to develop information about the existence of and transactions with potential related parties, there will be an unacceptable risk that the financial statements will be materially false and misleading, primarily as a consequence of a lack of adequate disclosure.

Secondarily, because by definition related party transactions are not arm's-length in nature, there is the possibility that either financial statement recognition or measurement might have been improperly effected for such transactions. Clearly, unless and until the auditors have flushed out all potential related party relationships, they would be unable to address the various recognition, measurement, presentation or disclosure issues that could be material to the financial statements and to the users' decisions regarding the entity.

Thus, although identification of otherwise undisclosed (or perhaps unrecognized) related parties is a somewhat challenging task, all experienced and qualified auditors are well aware of the critical importance of this undertaking. Unless the auditors can be satisfied that all related parties have been identified, and that transactions and balances have been properly accounted for and disclosed, they would be precluded from rendering an unqualified opinion on the financial statements.

In the authors' experiences, it is not only auditors that fail in their responsibilities in this area; even seasoned litigators, in pursuit of actions against companies and their auditors for other financial reporting infractions, commonly overlook these ubiquitous failings, which only experienced litigation-oriented accountants seem able to reliably flag. As further revelations about financial reporting missteps by Chinese RTO companies are unveiled, it is anticipated that a sizable portion of all supposed faults will pertain to this singular matter of missing required disclosures, the absence of which can make a world of difference in the how a company is seen by investors.

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