The Role of Related Party Transactions in Fraudulent Financial Reporting

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ABSTRACT

Motivated by auditing regulators' recent interest in related party transactions (RPTs), this study examines SEC enforcement actions that involved RPTs. Specifically, we compare fraud cases involving RPTs with comparable fraud cases that did not involve such transactions. We find that frauds involving RPTs had a lower impact on financial statements, but were more likely to involve misappropriation and to involve a top executive (CEO and/or CFO) in some aspect of the fraud. We also find weaker evidence that frauds involving RPTs persist for longer time spans. In addition, we provide a framework to document the types of related party transactions actually occurring in these fraud cases. Overall, the most frequent types of transactions in the enforcement actions were loans to related parties and payments to company officers for goods or services that were either unapproved or non-existent. Generally, related party transactions are not necessary as mechanisms for fraud, and their presence need not indicate fraudulent financial reporting. An implication is the importance of evaluating related party transactions within the broader corporate context.

Keywords: Related party transactions, fraudulent financial reporting.

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I. Introduction

Many high profile accounting frauds in recent years (e.g., Enron, Adelphia, Tyco, Refco, Hollinger, Rite Aid) have involved related party transactions (RPTs) in some way, creating concern among regulators[1] and other market participants about the appropriate monitoring and auditing of these transactions.[2] Yet, research has provided a mixed picture of the role of RPTs in fraudulent financial reporting. For example, disclosure research has shown that RPTs are quite common (*Wall Street Journal* 2003; Gordon *et al.* 2004a). However, since fraudulent financial reporting is relatively *un*common (Lev 2003), and furthermore most frauds[3] apparently do *not* involve RPTs (Shapiro 1984; Bonner *et al.* 1988; SEC 2003), it is reasonable to assume that most disclosed RPTs are not fraudulent. In auditing research, failure to identify RPTs was found to be one of the top ten audit deficiencies in a study of enforcement actions by the Securities and Exchange Commission (SEC) against auditors (Beasley *et al.* 2001). Other research, however, has shown that RPTs were no more common among companies committing fraud than those not committing fraud (Bell and Carcello 2000) and that external auditors do not consider the existence of RPTs to be among the most significant audit risk factors (Heimann-Hoffman *et al.* 1996; Apostolou *et al.* 2001; Wilks and Zimbleman 2004).

To gain a better understanding of the role of RPTs in fraudulent financial reporting, this study focuses on SEC enforcement actions involving RPTs.[4] Of the over 1,300 SEC Accounting and Auditing Enforcement Releases (AAERs) issued between October 1999 and December 26, 2006, 66 include the

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[1] The Chief Auditor of the Public Company Accounting Oversight Board (PCAOB) identified RPTs as an upcoming project for the PCAOB (PCAOB 2006). Additionally the International Auditing and Assurance Standards Board (IAASB) recently issued International Standard on Auditing 550 on Related Parties (IAASB 2008).
[2] See Gordon *et al.* (2007) for a synthesis of relevant research, prepared in connection with the Public Companies Accounting Oversight Board's review of auditing standards for RPTs.
[3] In this paper, fraud is defined as in *SAS 99* (AU 316): "an intentional act that results in a material misstatement in financial statements that are the subject of an audit." Fraud includes "intentional misstatements or omissions of amounts or disclosure in financial statements designed to deceive financial statement users… and misstatements arising from misappropriation of assets" (AICPA 2002a).
[4] All SEC enforcement actions involve financial reporting violations; however, not all SEC enforcement actions involve reporting violations considered to be fraud as legally defined. For example, of 869 parties named in SEC enforcement actions for financial reporting violations between July 31, 1997 and July 30, 2002, 593 (68%) were charged with fraud (SEC 2003).

terms "related party," "related-party" or "self-dealing" in the context of describing a fraudulent and/or undisclosed transaction with a related party. In contrast with the relative paucity of AAERs mentioning RPTs, specific standards exist both for reporting RPTs and for auditing RPTs, indicating the importance of this type of transaction. Why is such high attention accorded to RPTs by standard-setters given the low frequency of enforcement actions involving RPT frauds? One potential explanation is that the disparity indicates that standard-setters' attention is misplaced. Another is that the reporting standard effectively provides transparency and that the auditing standard effectively increases scrutiny, so outright fraud is deterred. A third, non-mutually exclusive, alternative explanation is that the standard-setters' attention to RPTs is warranted because fraudulent RPTs actually occur more frequently than suggested by the frequency of enforcement actions against them because their greater complexity hinders detection and investigation. These three explanations are, however, not testable. A fourth alternative explanation is that despite infrequency of occurrence, when fraud does occur, the existence of an RPT increases the impact of the fraud. Our study examines this fourth explanation.

The first objective of this study is to compare characteristics capturing the severity of fraud impact (e.g., financial impact, duration, involvement of top executives, and instance of misappropriation of assets) across frauds that involved RPTs and frauds that did not involve RPTs.[5] We identify cases that involved RPTs – either as the sole aspect of fraudulent reporting activity or as one aspect of broader fraudulent reporting ("RPT frauds"), which we compare with a random sample of cases that did not involve RPTs ("non-RPT frauds"). Our total sample includes 84 fraudulent financial reporting cases described in 393 AAERs dated from October 1999 (the earliest on the SEC website) through December, 2006. We find that although the frauds involving an RPT had a lower financial statement impact, they were more likely to have involved misappropriation of assets and to have involved a top executive (CEO and/or CFO) in some aspect of the fraud. We also find weaker evidence that RPT-frauds spanned a longer time period than non-RPT frauds.

[5] We examine extreme cases of fraud that involve RPTs; a separate but related research question is the relationship between earnings management and RPTs (Gordon and Henry, 2005).

The second objective of this study is to document the role of RPTs when they occurred. In documenting the role of RPTs, we provide a framework to categorize RPTs based on their business purpose. We also distinguish between RPTs that resulted in fraudulent financial reporting and RPTs that also involved misappropriation of assets. Among the types of RPTs in the AAERs, the most frequent type was the purchase of goods or services from related parties, in which payment was made, but the purchase was either undisclosed, unapproved, or non-existent. The next most frequently occurring type of RPT was lending, i.e., extending loans that were improperly disclosed and/or improperly valued to related companies and to executives (in periods prior to the Sarbanes-Oxley Act of 2002 which specifically prohibits loans to executives).

The remainder of this paper is organized as follows. In the next section, we first discuss issues of terminology and then summarize the academic research on RPTs. The third section describes our sample selection and analysis comparing cases in which a fraudulent RPT was present to those cases which did not involve a fraudulent RPT. In the fourth section, we document the role of RPTs in the cases that were the subject of SEC enforcement actions. The final section concludes and provides ideas for future research.

II. Background and Related Research

Terminology issues: What is meant by "related party transaction"?

Every transaction a company undertakes is with either a related or an unrelated counterparty, i.e., with a counterparty who has some extra-transaction relationship with the company through employment, ownership, or both;[6] or with a counterparty who has no extra-transaction relationship with the company.

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[6] Related parties are defined as follows."Related parties include: a.) Affiliates of the entity, b.) Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825–10–15, to be accounted for by the equity method by the investing entity, c.) Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management, d.) Principal owners of the entity and members of their immediate families, e.) Management of the entity and members of their immediate families, f.) Other parties with which the entity 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, g.) Other parties that can significantly influence the management or operating policies of the transacting parties or that have

For financial reporting purposes, it is not purely the "related party-ness" of a transaction that warrants particular attention, but rather the transaction's potential economic effect on the company.

Every payment to an employee or manager – salary, expense reimbursement, equity-based compensation – is a transaction with a party who is related to the company via employment. Financial accounting standards limit which of these transactions require disclosure. Specifically, Accounting Standards Codification Section (ASC) 850-10-50 *Related Party Disclosures* (FASB 2009) specifies that only material transactions outside the "ordinary course of business" need be disclosed. Every payment to a director – director fees, equity-based compensation, extra consulting fees – is a transaction with a party who is related to the company via board membership. The SEC requires non-financial statement disclosure of director compensation and of transactions meeting certain criteria, e.g. those in excess of $120,000 in which a related person (directors or other related persons) has a direct or indirect material interest (SEC Regulation S-K; SEC 2006). The issue with transactions involving managers or directors is that in such transactions, shareholders' interest may be particularly susceptible to being treated with lower priority than the managers' or directors' personal interest. At one extreme, such transactions are simply equitable compensation; at the opposite extreme, payments in such transactions are simply misappropriation of the company's assets.

Every transaction between a parent company and its subsidiaries or controlled companies, or between two subsidiaries of the same company is a transaction with a party that is related to the company via ownership and/or control; however, disclosure is required only for transactions not eliminated in consolidation (ASC 850-10-50, FASB 2009). The issue is whether reported transactions, if not identified as being with a related party, might distort the economic reality of the company's financial position. Sales to a related party, for example, may not (a) be made on the same terms as sales to unrelated third parties, and/or (b) be as sustainable as sales to unrelated parties.

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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. (FASB 2009).

This paper uses the term related party transaction as defined in ASC 850 (FASB 2009) and SEC Regulation S-X, and encompasses "related person" transactions as defined in SEC Regulation S-K; in other words, we focus on RPTs that should be disclosed. There is potential for confusion in this terminology since fraudulent RPTs should not be undertaken at all, and it is somewhat inconsistent to say that a transaction that should never have occurred should be disclosed. So, more precisely, we use the term RPTs to refer to both of the following: (a) transactions which are not alleged to be improper, but which require disclosure as RPTs; and (b) improper transactions, which, if proper, would require disclosure as RPTs.

Another issue with terminology is the overlap between the term "related party transaction" and other terms including "self-dealing," "insider trading," and "tunneling." Self-dealing, as defined in Shapiro (1984), is "the exploitation of insider positions for personal benefit" where personal benefit is defined to include embezzlement or expropriation of funds, allocation of corporate contracts to businesses in which the insider has an interest, and the use of corporate resources for personal gain.[7] Djankov *et al.* (2005, 1) defined self-dealing to include actions taken by individuals who control a corporation (managers, controlling shareholders, or both) to "divert corporate wealth to themselves, without sharing it with the other investors." Djankov *et al.*'s (2005) examples of self-dealing include theft of a company's assets, taking corporate opportunities, excessive executive compensation, and self-serving financial transactions such as executive loans and equity issuance.[8] In research on non-U.S. public companies (which often have a controlling shareholder who is also a top manager), Johnson *et al.* (2000b, 23) use the term "tunneling" to refer to the "transfer of resources out of a company to its controlling shareholder…" using theft or fraud or "asset sales and contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities,

[7] Shapiro (1984) also included insider trading as a form of self-dealing.

[8] Djankov *et al.* (2005) created an anti-self-dealing index for 72 countries to measure the extent to which a country's regulatory environment protects minority shareholders from expropriation via self-dealing by those who control a company (majority shareholders, managers or both). The study ranked the U.S. below the world average (and the English-law average) on two aspects: (i) public control of self-dealing such as fines and prison terms for offenders; and (ii) ex-ante private control of self-dealing, primarily pre-transaction approvals. The study ranked the U.S. well above both averages on ex-post private control of self-dealing such as disclosure and ease of litigation.

and so on." Variations in terminology describing RPTs, combined with the wide variety in transaction structures, highlight the need for specific descriptions as provided in the current study.

Most disclosed RPTs are probably not fraudulent

Even with regulators' limitations on which transactions require disclosure, disclosures of RPTs are common. Gordon *et al.* (2004a) report that 80% of 112 companies studied in a pre-Sarbanes-Oxley period (2000 to 2001) disclosed at least one RPT. Additionally, a business press article reports that 75% of the 400 of the largest U.S. public companies in a post-Sarbanes-Oxley period (2002-2003) disclosed one or more RPT (*Wall Street Journal* 2003).

In contrast, fraudulent financial reporting – at least that which is detected – is relatively rare. Lev (2003, 40) reports there were only about 100 federal class action lawsuits alleging accounting improprieties annually (study period 1996 to 2001), compared to the universe of over 15,000 companies listed on U.S. exchanges, and notes that "Overall, the direct, case-specific evidence on the extent of earnings manipulation from fraud litigation, earnings restatements and SEC enforcement actions suggest that such occurrences are relatively few in normal years...."

Since most companies disclose at least one RPT (even with the numerous limitations on which transactions must be disclosed) but few companies have been found to engage in fraudulent financial reporting activities, it is reasonable to assume that most disclosed RPTs are not fraudulent.

Frauds need not involve RPTs

Any misappropriation of a company's assets by an executive could be called an RPT (albeit a fraudulent one). However, frauds need not involve RPTs, and prior research suggests that most securities law violations investigated by the SEC did not involve RPTs. Some evidence on the prevalence of RPTs occurring in fraud cases can be gleaned from previous empirical research on SEC enforcement actions. Based on a random sample of SEC investigations in the period between 1948 and 1972, Shapiro (1984) reported that of 228 cases of violations by securities-issuing companies, 21% involved misrepresentations

about corporate insiders.[9] Such misrepresentations included "their background, compensation, financial interests, and self-dealing" (Shapiro, 1984, 10). In addition, 15% of the securities violations cases involved self-dealing, an example of which follows:

> "[A company's founder who incorporated his business, took it public, and remained the major shareholder] used the corporation for his own financial benefit, however, netting himself a great deal of money and depleting corporate coffers until its eventual bankruptcy. For example, he bought metal at 5 cents/pound but sold it to the company for 27-38 cents/pound which then processed and sold it, though unable to make a profit. He created other personal companies that would process corporate products at great profit without performing any actual function for example, buying saws from the corporation at $8.50 and selling them at $16, utilizing corporate resources to make the distribution." (Shapiro 1984, 20)

The number of violations in the Shapiro study involving RPTs could be higher than the 15% and 21% specifically included in the self-dealing and insider misrepresentation categories, respectively, because other categories of violations used in the study apparently include RPTs. Two examples illustrate. First, within the category of misrepresentation, Shapiro (1984, 14) described a case in which a company "failed to reveal the subsidiary status of certain companies classified as customers" (i.e., these were sales to a related party which were not disclosed as such). Second, within another category (misappropriation), Shapiro (1984, 18) described a case in which "the general partner of a limited partnership … doubled his salary without authorization; utilized corporate funds to extend loans to himself and other businesses in which he had an interest…" (i.e., RPTs). Despite variations of terminology, Shapiro's study suggests that RPTs were involved in far fewer SEC securities violations cases than, for example, registration violations (75% of cases), misrepresentations about the status of a corporation and its future (58% and 40%, respectively), or misrepresentations about a stock offering (50% of cases).[10]

Bonner *et al.* (1998) examined litigation for a sample of 261 companies with SEC enforcement actions between 1982 and 1995 and reported that 17% of their sample had related party disclosure problems and 2% had fictitious sales to related parties. Other research on SEC enforcement actions (Feroz

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[9] This study was published as part of a series (the Yale Studies on White-Collar Crime) prompted by the prevalence of white-collar crime in the 1970's.

[10] The percentages sum to more than 100% since some companies were accused of multiple security violations.

et al. 1991; Dechow *et al.* 1996; Beneish 1997; Beasley *et al.* 2000)) also reported the type of violations, but the role of RPTs, if any, was not part of their research focus.

More recently, an SEC study of enforcement actions involving reporting violations during the period July 31, 1997 to July 30, 2002 found that only 23 (10%) of 227 enforcement cases involved failure to disclose RPTs (SEC 2003). Overall, the study results suggest that failure to disclose RPTs was involved in far fewer reporting violations enforcement cases than, for example, improper revenue recognition (found in 56% of the cases) or improper expense recognition (44% of cases) (SEC 2003). However, because the role of RPTs *per se* was not a focus of the SEC study, it is not clear whether some of the study's other categories of improper accounting might have involved RPTs.

While the above studies provide information about the frequency of RPTs in fraudulent financial reporting, other research has addressed the relative importance of RPTs as a fraud risk indicator, with somewhat mixed conclusions. Bell and Carcello (2000), using a sample of 382 fraud and non-fraud audit engagements from a multinational CPA firm, note that the rates of occurrence of "significant and unusual related party transactions" were about the same in fraud cases and non-fraud cases. Thus, the authors conclude that "although significant and unusual related-party transactions may be contributing factors in some frauds, absent other risk factors, their mere presence does not appear to elevate the risk of fraud" (Bell and Carcello 2000, 174). Certain other research, consistent with the notion that the mere presence of RPTs does not necessarily elevate the risk of fraud, indicates that external auditors do not view the presence of RPTs as among the most significant indicators of potential fraud (Heimann-Hoffman *et al.* 1996; Apostolou *et al.* 2001; Wilks and Zimbleman 2004). Somewhat in contrast, however, one study showed that a sample of 77 internal auditors viewed RPTs as one of the most important red flags in detecting fraudulent activity (Moyes *et al.* 2005). Further, Beasley *et al.* (2001) reported that failure to recognize and/or disclose transactions with related parties was one of the top ten audit deficiencies in a sample of 45 SEC enforcement actions between 1987 and 1997.

Although audit research has addressed the general importance of RPTs in auditing and in detecting fraud, we are not aware of research that compares frauds involving an RPT with frauds that do not. Further, little research has addressed the nature of RPTs related to fraud in the U.S. environment.[11]

III. Methodology and sample

To select the SEC enforcement cases used in this study (see Table 1), we used a multi-step process. First, we searched 1,302 AAERs, representing all available[12] AAERs issued between October 1999 (the earliest date of AAERs posted on the SEC website) and December 2006, using the search terms "related party", "related-party" and "self-dealing" (collectively, the "search terms".) Although 80 AAERs included one or more of those search terms, only 66 used the terminology in the context of describing a fraudulent and/or undisclosed transaction with a related party; the other 14 included the term generically – either as the title of a section listing the entities relevant to an AAER or as part of a quoted auditing standard.[13] Several AAERs may be filed for actions related to a single company, so we organize the actions by company, and refer to each as a case (31 total RPT-fraud cases). We then identified all additional AAERs concerning any of the RPT cases by searching for the company names; the 31 RPT cases were referenced in a total 148 AAERs. From the remaining 1,154 AAERs not involving any of the RPT cases, we selected a random sample of 66 AAERs, which again we organized by case. After excluding AAERs with insufficient information on the amount of the fraud and overlapping cases, we ended with a sample of 53 non-RPT fraud cases.

[11] Relevant international research is somewhat more extensive than U.S.-based, primarily because the greater frequency of controlling shareholders in the ownership structure of non-U.S. public companies makes expropriation of minority shareholders and lenders via self-dealing a more broadly applicable issue (e.g. Johnson *et al.*, 2000a, 2000b) However, the examples provided in those studies are not necessarily in violation of local laws, whereas our study of SEC enforcement actions relates, by definition, specifically to instances where securities laws are broken.

[12] The SEC website (http://www.sec.gov/divisions/enforce/friactions.shtml) provides the following disclaimer regarding available AAERs: "This list … is not meant to be a complete and exhaustive compilation of all of the actions …."

[13] GAAS requires that the auditor plan the audit "to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" (AU 316.01). In planning, the auditor must assess the risk of material misstatement due to fraud or error, which includes consideration of "conditions that may require extension or modification of audit tests, such as the risk of material errors or irregularities or the existence of related party transactions" (AU 311.03; see also AU 316A ("Consideration of Fraud in a Financial Statement Audit")).

Descriptive Statistics of Companies Involved

Financial information, either from the last clean financial statement of the company or from Compustat, was available for a portion of the companies involved. Table 2 presents data on selected financial statement items. RPT fraud cases involved slightly smaller companies than the non-RPT fraud cases, based on average assets, net income, revenue, and stockholders' equity; however, none of the differences are statistically significant (*t*- statistics not shown). For both RPT fraud cases and non-RPT fraud cases, the relatively low median assets, income, revenue and stockholders' equity indicate that the sample includes numerous small companies.[14]

Quantitative and Qualitative Significance of the Frauds

To capture the quantitative and qualitative significance of the frauds, we examine the following four characteristics: the financial statement impact,[15] the duration, the involvement of key individuals in the fraud, and the existence of misappropriation in addition to misstatement.

Similar to Feroz *et al.* (2004), we measure the financial statement impact as the absolute value of the cumulative amount of misstated income scaled by income as reported. Most AAERs present the amount of fraud in terms of the impact on income, but some AAERs present the amount of fraud in terms of revenues or assets. To obtain a uniform estimate of the financial statement impact across frauds, we make the assumption that each firm's reported financial statements reflect the same return on sales (ROS) or return on assets for both fraudulent amounts and non-fraudulent amounts. So, where an AAER presents the amount of fraud in terms of revenue, for example, we estimate the *Fin_impact* as a percentage of income by assuming that ROS_{Fraud} equals $ROS_{Reported}$ in the following equation:

[14] Untabulated industry distribution (by two-digit SIC codes) of our sample shows that three SIC codes comprise 40.7% of the RPT fraud cases: SIC codes 67 (Holding and other investment offices), SIC code 73 (Business services) and SIC code 38 (Instruments and related products). For the non-RPT fraud cases, two SIC codes (73 (Business services) and 36 (Electrical and electronic equipment)) comprise 37.3%.

[15] We choose to measure financial statement impact rather than market impact because prior research has established that difficulties exist in determining the timing of market knowledge of the fraud (Feroz *et al.* 1991) and because the potential of other factors influencing market prices.

$$Fin_impact = \frac{\text{Revenue}_{Fraud}}{\text{Revenue}_{Total Reported}} \times \frac{ROS_{Fraud}}{ROS_{Reported}} = \frac{\text{Income}_{Fraud}}{\text{Income}_{Total Reported}}$$

Table 3 reports the mean *Fin_impact* for the RPT fraud cases and non-RPT fraud cases as 1.13% and 2.24% in Panel A and Panel B, respectively, although this difference is not statistically different (*t*-statistic = 1.15, *p*-value = 0.256 provided in Panel C).

Duration of misstatement has been used in prior research to capture the significance of restatements, which are situations that often involve fraud (Palmrose *et al.* 2004). The duration of a fraud signifies how long the control failure persisted in a firm. Our measure of this qualitative aspect of fraud significance, *Duration*, is the number of days elapsed between the first and last fraudulent financial statement referenced in the AAERs. As shown in Table 3, the mean duration of the RPT fraud cases is 836 days, which is significantly longer than the mean duration of the non-RPT fraud cases of 576 days (*t*-statistic = 2.60, *p*-value = 0.011).

The "tone at the top" is generally accepted as a critical underpinning of a firm's governance, control, and fraud prevention (e.g., Castellano and Lightle 2005; Schwartz et. al. 2005); thus, the involvement of top executives as perpetrators of a fraud is an important qualitative aspect of fraud significance. The involvement of key corporate personnel has also been used in prior fraud research to indicate the significance (Beasley *et al.* 1999). Our measure of this qualitative aspect of the significance of a fraud, *CEO/CFO*, is an indicator equal to 1 if the AAERs for a case named the Chief Executive Officer, Chief Financial Officer, or both, as perpetrators. As reported in Table 3, for 27 of the fraud cases involving an RPT (87.1 percent of the 31 total cases) the AAERs named the CEO and/or the CFO as a perpetrator. (The senior executive (s) was directly involved in an RPT in some, but not all cases.) The two top executives of a firm are significantly more likely to have been named as perpetrators in fraud cases involving an RPT than in those not involving an RPT (*p*-value of *Chi*-square 0.010 reported in Panel C).

Our fourth measure of the significance of a fraud case is whether it involved misappropriation of assets in addition to fraudulent financial reporting. We identify the existence of misappropriation of assets

(i.e., direct personal enrichment) based on the descriptions in the AAERs. As shown in Table 3, we find that of the 31 fraud cases involving RPTs, 17 (55 percent) of the cases involved misappropriation of assets in addition to fraudulent financial reporting (The RPT itself was the means by which assets were appropriated in some, but not all cases). For the 53 cases not involving RPTs, only three involved misappropriation of assets. This difference is statistically significant (*p*-value of *Chi*-square < 0.0001).

Panel D of Table 3 presents a correlation matrix of the variables measuring these four characteristics of the fraud cases. Because the indicator variable *RPTFraud* equals 1 if the case involved an RPT, and 0 otherwise, the correlations between *RPTFraud* and the four characteristics mirrors the discussion above. Among the four variables, only *Duration* and *CEO/CFO* show significant correlation. This suggests that frauds involving the most senior executives of a firm persist for a longer period of time.

Logistic regression

To investigate how the quantitative and qualitative aspects of fraud impact, collectively, differ between RPT frauds and non-RPT frauds, we use a logistic regression. The dependent variable is the indicator variable *RPTFraud*, which is equal to 1 when the case involved an RPT and 0 otherwise. Note that the logistic regression here is used to identify statistically significant differences between characteristics of RPT frauds and non-RPT frauds and does not imply causality in either direction. Specifically, we estimate the following:

$$RPTFraud_i = \alpha + \beta_1 Fin_impact_i + \beta_2 Duration_i + \beta_3 CEO/CFO_i + \beta_4 Misappropriation_i + \varepsilon$$

where
RPTFraud is an indicator variable = 1 if the fraud involves an RPT, 0 otherwise,
Fin_impact = $\text{Income}_{\text{Fraud}}/\text{Income}_{\text{Reported}}$,
Duration = the duration of the fraud measured in days,
CEO/CFO = 1 if the CEO, the CFO, or both were named as perpetrators in the AAERs for the case, and 0 otherwise, and
Misappropriation = 1 if the fraud involved misappropriation of assets in addition to fraudulent financial reporting, and 0 otherwise.

Table 4 presents the results of the regression. Three of the independent variables are statistically significant. The coefficient on *Fin_impact* is -0.272 (*p*-value = 0.06) indicating that dollar amounts of the fraud, relative to amounts reported, are relatively lower for RPT-fraud cases than for non-RPT fraud

cases. The coefficient on *CEO/CFO* is 1.505 (*p*-value = 0.05) indicating that RPT fraud cases are more likely to involve the CEO and/or CFO than are non-RPT frauds. Finally, the coefficient on the variable *Misappropriation* is 3.419 (*p*-value = 0.0001), indicating that RPT-frauds are more likely to involve misappropriation of assets than are non-RPT frauds. Due to the significant correlation between *Duration* and *CEO/CFO* noted above, we repeat the regression excluding each of the two variables in turn. Results (not tabulated) are robust to these modifications, namely when only *Duration* is excluded, the coefficients on all other explanatory variables remain significant, and when only *CEO/CFO* is excluded, the coefficients on all other explanatory variables remain significant.

Overall, our results suggest that an RPT-fraud is more likely than a non-fraud RPT to have involved one or both top executives, misappropriation, and a lower relative dollar amount. One explanation of the lower dollar amount is that fraudulent RPTs are used more for direct, personal enrichment, so amounts of RPT frauds, while representing a lower percentage of the firm's income than non-RPT frauds, could nonetheless be significant to an individual executive.

IV. The types of RPTs in fraudulent financial reporting

To complement the statistical analysis exploring differences in the characteristics of frauds involving RPTs, we next turn to an examination of the role of the RPT in the fraud, as described in the AAERs. We establish a framework organized according to the business purpose of the transaction – generally, operating and financing. The categories we use are: (a) sales to (purchases from) related parties of goods (inventory), assets (other than inventory), and services; (b) borrowings from (loans to) related parties; and (c) investments in (sale of equity stake to) related parties. Within each type of transaction, we highlight the feature or features of a related party transaction that led (or in the case of no occurrences in our sample, would lead) to misstatement and misappropriation of assets. Within misstatements, failure to disclose a material related party transaction is itself a misstatement, whether or not the transaction included improperly reported elements and/or was economically disadvantageous to the company. In the

31 cases involving RPTs, the AAERs specifically mention 55 individual transactions. Table 5 categorizes these transactions according to the framework.

Sales to (purchases from) related parties of goods and services to misstate financial reports, or to misappropriate assets, i.e. wrongly transfer wealth

Fictitious sales to a related party (including round-trip sales[16]) and/or mischaracterizing receipts as revenues overstate revenue. Actual sales to a related party may occur on more favorable terms than sales to unrelated third parties and/or may not be as sustainable as sales to unrelated parties; therefore, failure to disclose related-party sales can mislead users of financial statements. Actual sales to a related party on more favorable terms than sales to third parties (i.e., at below-market prices) can be used for misappropriation, wrongly transferring wealth to the related party. Of the 55 transactions, nine involved sales to related parties, with only two specifically described as being below market in the AAERs.

Similarly, purchases of non-existent or unnecessary goods or services, or purchases made at above-market prices, can be used for misappropriation; and failure to disclose related-party purchases can mislead users of financial statements. Of the 55 transactions in our sample of AAERs, 19 (34.5%) involved purchases from related parties. Many of these transactions involved purchasing assets from related parties and then over-valuing the assets to inflate the size of the company. Others involved purchasing non-existent or unapproved services from a related party as a means of justifying disbursements to the party and thus misappropriating the assets of the firm. Purchases from related parties (8 transactions) were the most frequently occurring (14.5 %) means of misappropriation in the sample.

The opposites of these transactions, e.g., sales of assets to related parties at above-market prices in order to disguise a transfer wealth from the related party, are possible and might serve to smooth income or to shore up an otherwise failing company.[17] The AAERs do not describe any of that type of

[16] Round-trip sales "involve simultaneous pre-arranged sales transactions often of the same product in order to create a false impression of business activity and revenue" (SEC 2003, 25).
[17] Such a transaction would serve the role of "propping," i.e., one entity undertakes transactions that are otherwise not in its own economic interest, but serve only to maintain the financial health of another entity. For example, a controlling shareholder might inject private funds into a financially troubled public company. Academic research has studied propping transactions in markets where corporate ownership structures and aspects of the legal system

transaction, consistent with the usual presumption that fraudulent financial reporting would typically occur in connection with a transfer of wealth to the related party, i.e. a misappropriation of a company's assets.

Borrowings from (loans to) related parties to misstate financial reports, or to misappropriate assets, i.e. wrongly transfer wealth

Non-recognition of borrowings from a related party or non-disclosure of obligations incurred for the related party via a guarantee or co-borrowing results in understated liabilities. When recognized, loans to a related party for which collectability is over-estimated overvalues these assets. Either borrowing from a related party at above-market interest rates, or lending to a related party at below-market interest rates can transfer wealth to the related party, i.e. serve as the means to misappropriate a company's assets. Financing from a related party at below-market rates or off-market terms transfers wealth from the related party to the company, a practice referred to as propping (Freidman *et al.* 2003). In our sample, loans from related parties are relatively few, but loans to related parties are the second most frequently occurring type of RPT described in the AAERs (16 transactions, 29.1 percent of the total). In addition, the second most common type of RPT described in AAERs as being used to misappropriate assets were loans to related parties (6 transactions). This result supports the prohibition by Sarbanes-Oxley Act of 2002 on loans to executives.

Investments in (sales of equity to) related parties to misstate financial reports or to misappropriate assets, i.e. wrongly transfer wealth

Investment in the equity of a related party, if reported incorrectly, can lead to the overstatement of assets and/or regulatory capital. Related party investments in the company's equity, if reported incorrectly, can mislead investors about insider activity. Finally investing in the equity of a related party at above-market prices, or selling an equity interest to the related party at below-market prices can

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create economic benefits to such transactions. See, for example, Friedman *et al.* (2003). Further examples of propping are described in our discussion of loans from related parties, below.

transfer wealth to the related party. Of the 55 RPTs cited in the AAERs, only one involved an investment in a related party, and fewer than 10 percent of the transactions involved sales of equity to related parties.

V. Conclusions and implications for future research

This paper investigates the role of RPTs in fraudulent financial reporting. In our examination of the quantitative and qualitative impact of RPT-frauds compared to non-RPT frauds, we find that frauds involving RPTs have a smaller financial impact than frauds that do not. However, frauds than involved RPTs are more likely to have involved the CEO and/or CFO and to have involved misappropriation of assets than are non-RPT frauds. Taken together, these findings are consistent with the argument that -- conditional on the existence of fraud -- the existence of a related party transaction increases the qualitative, if not the quantitative, impact of the fraud.

We also document the role of RPTs in the AAER cases involving such transactions, categorized according to the type of underlying business activity. The most frequent type of transactions in the enforcement actions were loans to related parties and purchases of goods and services from related parties, some of which were cited only as being undisclosed and some of which involved payments to company officers for services that were either unapproved or non-existent. In some of the cases, RPTs were central to the fraud (e.g., misstatements were perpetrated by recording fictitious sales to a related party or misappropriations were perpetrated by unauthorized and/or undisclosed payments to a related party for services). In other cases, the RPTs were more peripheral; for example, the primary misstatement was achieved with no involvement of an RPT through inflating inventory to understate cost of goods sold, and the AAER mentioned only briefly that the company also failed to disclose an RPT.

Results of our study have two important implications for auditing RPTs. First, with respect to CEO/CFO involvement, the existence of RPTs is usually disclosed in the management representation letter provided to the auditor and signed by the CEO and CFO. However, due to the positive association between RPT frauds and CEO/CFO involvement we find in this study, the potential complicity of the CEO and CFO raises questions about the credibility of such representations. This finding raises the

potential importance of one audit procedure suggested in the Quality Control Inquiry of the AICPA Practice Section which recommends "…obtaining representation letters from individuals below the level that is currently required, such as from the Vice-President of Sales or Controller" (AICPA 2002b, 7). A second implication arises from the finding that misappropriation of assets is more likely in an RPT fraud than a non-RPT fraud. Existing auditing standards, specifically *SAS 99* which does not include misappropriation of assets through related party transactions as a fraud risk factor (AICPA, 2002a), are inconsistent with this finding.

Our study examines RPTs conditional on the existence of fraud. Many firms disclose RPTs that are not associated with fraud, and future research could investigate indicators that might distinguish a non-fraudulent, disclosed RPT from a fraudulent one.

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Table 1
Sample Selection of Enforcement Cases
Cases are Defined by Company Involved

	RPT Cases	Non-RPT Cases	Totals
Total AAERs searched	80[a]	1,222[b]	1,302
Less RPT-mention AAERs using the terminology generically	(14)	14	
Total RPT-mention AAERs	**66**		
Less additional AAERs relating to RPT cases		(82)	
Total Non-RPT AAERs		1,154	
Randomly selected AAERs from non-RPT AAERs		**66**	
Less overlapping cases, or inadequate detail	35	13	
Total cases	31[c]	53[d]	84[e]

[a] AAERs that mention of any the search terms "related party", "related-party", "self dealing", or "self-dealing" (collectively, the "search terms".)
[b] AAERs that do not mention any of the search terms.
[c] In addition to the 66 AAERs which include at least one of the search terms, a total of 82 AAERs relate to the *cases* identified as RPT cases but do not mention the search terms. The 31 RPT cases were referenced in a total of 148 AAERs.
[d] The 53 non-RPT cases were referenced in a total of 245 AAERs.
[e] In total, the 84 cases were referenced in a total of 393 AAERs.

Table 2
Financial Characteristics of Companies Involved in Fraudulent Financial Reporting Cases Involving/Not Involving RPTs
($ thousands)

Panel A. Financial Characteristics of Companies in Fraudulent Financial Reporting Cases Involving RPTs (*n*= 31)[a]

	n	Mean	Median	Std. Dev.	Maximum	Minimum
Total Assets	25	$2,670,392	$111,280	$7,358,725	$33,381,000	$6,509
Net Income	25	$47,179	$765	$215,381	$1,024,000	$(240,719)
Revenue	25	$2,247,771	$36,401	$8,058,441	$40,112,000	$724
Total Stockholders' Equity	25	$782,199	$53,190	$2,042,652	$9,570,000	$(4,980)

Panel B. Financial Characteristics of Companies in Fraudulent Financial Reporting Cases not Involving RPTs (*n*=53)[a]

	n	Mean	Median	Std. Dev.	Maximum	Minimum
Total Assets	51	$3,141,710	$83,568	$13,035,122	$91,072,000	$0
Net Income	51	$118,219	$3,344	$603,909	$3,941,000	($844,000)
Revenue	51	$2,381,706	$100,652	$6,911,415	$37,120,000	0.0
Total Stockholders' Equity	51	$1,443,888	$40,579	$7,186,330	$51,238,000	($116,844)

[a]Data are based on the last financial statements prior to the fraud period, or the earliest available data on Compustat.

T-statistics (not shown) do not indicate statistically significant differences for any of the financial characteristics between the two groups.

Table 3
Characteristics of Fraudulent Financial Reporting Cases Involving/Not Involving RPTs

Panel A. Fraudulent Financial Reporting Cases Involving RPTs (*n*= 31)

Continuous Variables	n	Mean	Median	Std. Dev.	Maximum	Minimum
Fin_impact (%)	31	1.13	0.60	1.59	7.89	0.03
Duration (days)	31	836	730	507	1826	0

Discrete Variables	n	Number	Percent
CEO/CFO	31	27	87.1
Misappropriation	31	17	54.8

Panel B. Fraudulent Financial Reporting Cases not Involving RPTs (*n*=53)

Continuous Variables	n	Mean	Median	Std. Dev.	Maximum	Minimum
Fin_impact (%)	53	2.24	0.41	6.77	47.00	0
Duration (days)	53	576	547	401	1461	0

Discrete Variables	n	Number	Percent
CEO/CFO	53	32	60.3
Misappropriation	53	3	5.7

Panel C. Comparison of Cases Involving RPTs and Cases not involving RPTs

Continuous Variables	*t*-statistic	*p*-value
Fin_impact (%)	1.15	0.256
Duration (days)	2.60	0.011

Discrete Variables	Chi-Square	*p*-value
CEO/CFO	6.68	0.010
Misappropriation	26.08	<0.0001

Fin_impact = $\text{Income}_{\text{Fraud}}/\text{Income}_{\text{Reported}}$; *Duration* = the duration of the fraud measured in days; *CEO/CFO* is an indicator variable = 1 if the CEO, the CFO, or both were named as perpetrators in the AAERs for the case, 0 otherwise; *Misappropriation* is an indicator variable = 1 if the fraud involved misappropriation of assets in addition to fraudulent financial reporting, 0 otherwise.

Table 3 (continued)
Characteristics of Fraudulent Financial Reporting Cases Involving/Not Involving RPTs

Panel D. Correlation Matrix of Fraud Characteristics
Pearson above the diagonal/ Spearman below the diagonal (*p*-values in italics)

	RPT Fraud	*Fin_impact*	*Duration*	*CEO/CFO*	*Misappropriation*
RPT Fraud	1.000	-0.099	0.276	0.282	0.557
		0.37	*0.01*	*0.01*	*<.0001*
Fin_impact	0.023	1.000	0.078	0.130	0.018
	0.84		*0.48*	*0.24*	*0.87*
Duration	0.238	0.033	1.000	0.253	0.195
	0.03	*0.77*		*0.02*	*0.08*
CEO/CFO	0.282	0.210	0.240	1.000	0.180
	0.01	*0.06*	*0.03*		*0.10*
Misappropriation	0.557	0.096	0.193	0.180	1.000
	<.0001	*0.39*	*0.08*	*0.10*	

RPTFraud is an indicator variable = 1 if the fraud involvess a RPT, 0 otherwise. *Fin_impact* = $Income_{Fraud}/Income_{Reported}$; *Duration* = the duration of the fraud measured in days; *CEO/CFO* is an indicator variable = 1 if the CEO, the CFO, or both were named as perpetrators in the AAERs for the case, 0 otherwise; *Misappropriation* is an indicator variable = 1 if the fraud involved misappropriation of assets in addition to fraudulent financial reporting, 0 otherwise.

Table 4
Results of Logistic Regression: Quantitative and Qualitative Aspects of Fraud Impact

$$RPTFraud = \alpha + \beta_1 Frauimpact_i + \beta_2 Duration_i + \beta_3 CEO/CFO + \beta_4 Misappropriation + + \varepsilon$$

Parameter	Estimate	Standard Error	Wald Chi-Square	(*p*-value)
Intercept	-2.795	0.818	11.67	0.00
Fin_impact	-0.272	0.145	3.49	0.06
Duration	0.001	0.001	2.16	0.14
CEO/CFO	1.505	0.775	3.77	0.05
Misappropriation	3.419	0.877	15.20	0.00

Psuedo R-Square 0.499
Likelihood Ratio Chi-square 38.142 ($p = <0.0001$)

RPTFraud is an indicator variable = 1 if the fraud involvess a RPT, 0 otherwise. *Fin_impact* = $Income_{Fraud}/Income_{Reported}$ *; Duration* = the duration of the fraud measured in days; *CEO/CFO* is an indicator variable = 1 if the CEO, the CFO, or both were named as perpetrators in the AAERs for the case, 0 otherwise; *Misappropriation* is an indicator variable = 1 if the fraud involved misappropriation of assets in addition to fraudulent financial reporting, 0 otherwise.

Table 5
Type and Frequency of RPTs in Fraudulent Financial Reporting Cases Involving RPTs By Misstatement Only versus Misstatement and Misappropriation of Assets[a]

Transaction Type	Description	Frequency	
Sales to related parties	Misstatement only: Undisclosed relationship. Improper accounting inflated revenues or gains.	7	12.7%
	Misstatement and Misappropriation: Sales at below market prices transferred wealth to RP.	2	3.6%
Purchases from related parties	Misstatement only: Undisclosed relationship. Over-valuation inflated assets.	11	20.0%
	Misstatement and Misappropriation: Purchases of services or assets at above market prices transferred wealth to RP.	8	14.5%
Loans from related parties	Misstatement only: Undisclosed relationship.	5	9.1%
	Misstatement and Misappropriation: Borrowing at above market prices would transfer wealth to RP	0	0.0%
Loans to related parties	Misstatement only: Undisclosed relationship. Over-valuation inflated assets.	10	18.2%
	Misstatement and Misappropriation: Lending at below market rates or disbursements characterized as a loan transferred wealth to RP.	6	10.9%
Investments in related parties	Misstatement only: Undisclosed relationship. Over-valuation would inflate assets.	0	0.0%
	Misstatement and Misappropriation: Investing at above market prices transferred wealth to RP.	1	1.8%
Sale of equity to related parties	Misstatement only: Undisclosed relationship.	3	5.5%
	Misstatement and Misappropriation of Assets: Selling at below market prices or transferred wealth to RP.	2	3.6%
	Subtotal of Misstatement only	*36*	*65.5%*
	Subtotal of Misstatement and Misappropriation of Assets	*19*	*34.5%*
	Total	55[b]	100%

[a]Certain transactions explicitly involved misappropriation, i.e., they were apparently the *means* by which assets were appropriated.
[b]Among the 31 cases a total of 55 separate RPTs were identified, i.e., some cases involved more than one RPT.