

The Role of Related Party Transactions in Fraudulent Financial Reporting

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ABSTRACT

Despite recent high profile frauds involving related party transactions, research has provided a somewhat mixed picture of the role of related party transactions in fraudulent financial reporting. To gain a better understanding of the role and prevalence of related party transactions in financial frauds, we examine 48 SEC enforcement actions involving fraud and related party transactions and document 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. For the subset of SEC enforcement cases involving external auditors, inadequate examination of the transaction (e.g., ascertaining its business purpose) was the most common alleged audit deficiency; few audits appear to have failed at the identification stage. Finally, the relative frequency of disclosed related party transactions combined with the relative infrequency of financial reporting fraud suggests that their co-occurrence is rare, although the prominence of frauds involving related party transactions may have created a perception that such co-occurrence is common.

Key Words: *Related party transactions, Fraud.*

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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 in some way, creating concern among regulators and other market participants about the appropriate monitoring and auditing of these transactions.¹ Yet, research has provided a mixed picture of the role of related party transactions in fraudulent financial reporting. For example, research has shown that related party transaction disclosures are quite common (Gordon et al. 2004a; *Wall Street Journal* 2003). However, since fraudulent financial reporting is relatively *uncommon* (Lev 2003), and furthermore most frauds² apparently do not involve related party transactions (Shapiro 1984; Bonner et al. 1988; SEC 2003), it is reasonable to assume that most disclosed related party transactions are not fraudulent. In auditing research, failure to identify related party transactions 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 has shown that related party transactions 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 related party transactions 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 and prevalence of related party transactions in fraudulent financial reporting, this descriptive study focuses on SEC enforcement actions involving both fraud and related party transactions.³ We examine 48 such cases as described in SEC Accounting and

¹ See Gordon et al. (Forthcoming) for a synthesis of relevant research, prepared in connection with the Public Companies Accounting Oversight Board (PCAOB)'s review of auditing standards for related party transactions.

² 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 2002).

³ 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

Auditing Enforcement Releases (AAER). The purposes of this study are to document the role of related party transactions in each case, and where relevant, to identify the aspect of auditing the related party transaction which the SEC identified as deficient.

We find that loans to related parties are the most frequent type of related party transaction in the enforcement cases examined, yet relatively few involve direct loans to executives, the only type of related party transaction now specifically forbidden under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The next most frequent type of related party transaction in the enforcement actions is payment to company officers for services that were either unapproved or non-existent. Another frequent type of transaction is the sale of goods or services to related parties in which the existence of the relationship was not disclosed, and the sales were either fictitious or improperly accounted for (e.g., loan proceeds or contingent sales improperly recorded as revenue).

Auditing related party transactions involves sequentially identifying related parties, examining related party transactions, and ensuring proper disclosure of the transactions. For the subset of 31 (of 48) related party enforcement cases in which an SEC action against an external auditor is identified, we find that the most common alleged audit deficiency with respect to the related party transaction involves inadequate examination of the transaction (e.g., ascertaining its business purpose). Surprisingly, relatively few audits appear to have failed at the identification stage.⁴

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 related party transactions. In the third section, we describe our approach to sample selection and methodology. The fourth section documents the role of related party transactions in the cases that were the subject of SEC enforcement actions. In the fifth section, we describe which aspect of auditing related party transactions – identification, examination, or disclosure – was identified as deficient by the SEC and provide the available details to enable some

enforcement actions for financial reporting violations between July 31, 1997 and July 30, 2002, 593 (68%) were charged with fraud (SEC 2003).

⁴ As with fraud, we may have a censored sample; i.e., it cannot be known how many undisclosed related party transactions have not yet been discovered.

inferences about potentially avoidable audit shortcomings. The final section concludes and provides ideas for future research.

II. Background and Related Research

Terminology issues: What is a 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;⁵ or with a counterparty who has no extra-transaction relationship with the company. 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 effect on the company’s financial reporting.

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, FAS 57 (FASB 1982, ¶12) specifies that only material transactions outside the “ordinary course of business” need be disclosed. The issue is that in such transactions, shareholders’ interest may be particularly susceptible to being treated with lower priority than the manager’s personal interest. 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). Every transaction between a parent company and its subsidiaries or

Comment [e1]: I think we should keep the wording so that the phrase “who is related to the company via employment” modifies the noun “party”. The other suggested edit would sound like the two phrases “with a related party” and “via employment” both modify “transaction.”

⁵ Statement of Financial Accounting Standards No. 57 (hereafter FAS 57) defines related parties as follows: “Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and 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. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has 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 1982, paragraph f.).

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, FAS 57 requires disclosure only for transactions not eliminated in consolidation (FASB 1982, ¶ 2). 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 be (a) made on the same terms as sales to unrelated third parties, and/or (b) as sustainable as sales to unrelated parties.

We use the term related party transaction as defined in FAS 57, SEC Regulation S-X, and SEC Regulation S-K; in other words, related party transactions that should be disclosed. There is potential for confusion in this terminology since fraudulent related party transactions 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 related party transactions to refer to both of the following: (a) transactions which are not alleged to be improper, but which require disclosure as related party transactions; and (b) improper transactions, which, if proper, would require disclosure as related party transactions.

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.⁶ 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

⁶ Shapiro (1984) also included insider trading as a form of self-dealing.

transactions such as executive loans and equity issuance.⁷ 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, and so on.” Variations in terminology describing related party transactions, combined with the wide variety in transaction structures, highlight the need for specific illustrative examples as provided in the current study.

Likelihood that disclosed related party transactions are not fraudulent

Even with regulators’ limitations on which transactions require disclosure, disclosures of related party transactions 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 related party transaction. 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 related party transactions (*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 related party transaction (even with the numerous limitations on which transactions must be disclosed) but few companies have been found to engage in

⁷ 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.

fraudulent financial reporting activities, it is reasonable to assume that most related party transactions are not fraudulent.

Prevalence of related party transactions in frauds

As noted above, frauds need not involve related party transactions, and prior research suggests that most security law violations investigated by the SEC did not involve related party transactions. Some evidence on the prevalence of related party transactions occurring in fraud cases can be gleaned from (a) key-word searches of AAERs and (b) previous empirical research on SEC enforcement actions.

Key-word searches of AAERs on Lexis-Nexis⁸ for the word “fraud” and “fraudulent” yield 910 and 689 documents, respectively. A key-word search for “related party” OR “related party transaction” yields 214 documents. However, a combined search for “fraud” AND “related party” yields only 89 documents, with dates spanning 20 years (from 1984 to 2005). A search for “fraud” AND “self-dealing” yields only 11 documents (dating from 1993 to 2005), six of which are duplicates with the previous search. While admittedly simplistic, these key word searches suggest the rarity of fraud involving related party transactions.

The results of these key-word searches are consistent with empirical research in this area. Based on a random sample of SEC investigations in the period between 1948 and 1972, Shapiro (1984)⁹ reported that of 228 cases of violations by securities-issuing companies, 21% involved misrepresentations about corporate insiders. 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

Comment [e2]: Agree we can delete the page reference. I needed it because the book has a lot of tables and I wanted to remind myself which one I was looking at.

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⁸ As of August 29, 2006.

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.

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 related party transactions 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 related party transactions. 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., related party transactions). Despite variations of terminology, Shapiro’s study suggests that related party transactions 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 (Beasley et al. 2000; Dechow et al. 1996; Beneish 1997; Feroz et al. 1991) also reported the type of GAAP violations, but the role of related party transactions, 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 related party transactions (SEC 2003). Overall, the study results suggest that failure to disclose related party transactions 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

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

(44% of cases) (SEC 2003). However, because the role of related party transactions *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 involve related party transactions.

While the above studies provide information about the frequency of related party transactions in fraudulent financial reporting, other research has addressed the relative importance of related party transactions 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 related party transactions does not necessarily elevate the risk of fraud, indicates that external auditors do not view the presence of related party transactions as among the most significant indicators of potential fraud (Apostolou et al. 2001; Heimann-Hoffman et al. 1996; Wilks and Zimbleman 2004). Somewhat in contrast, however, a study showed that a sample of 77 internal auditors viewed related party transactions 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 related party transactions in auditing and in detecting fraud, little research has addressed the nature of related party transactions related to fraud in the U.S. environment.¹¹

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. 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. For example, in a study of

III. Methodology

We select the SEC enforcement cases used in this study from several sources. First, we include the 12 cases identified in Beasley et al. (2001) in which the alleged deficiencies in performing an audit included failure to recognize or disclose related party transactions. Second, we identify an additional 34 cases from a search of all AAERs on Lexis-Nexis using the search words “related party” AND “fraud.”¹² Finally, we include Enron Corp. (Enron), and Refco Inc. (Refco), which though not identified by the Lexis-Nexis search, are included because of their size and high profile. As with fraud, we may have a censored sample; i.e., it cannot be known how many undisclosed related party transactions have not yet been uncovered. For this reason and also because of variations in terminology for related party transactions in enforcement actions, our data should be viewed as a sample of enforcement actions identified using our particular search methodology, and the results of our analysis should be viewed in this context.

To better understand the role of related party transactions in uncovered fraud, we establish a framework organized according to the following types of transactions: (a) sales to (purchases from) related parties of goods and services; (b) asset sales to (purchases from) related parties; (c) borrowings from (loans to) related parties; and (d) investments in (sale of equity stake to) related parties. Within each type of transaction, the feature or features of a related party transaction that would lead to misstatement and/or misappropriation are highlighted. The framework, presented in Table 1, distinguishes between

expropriation through self-dealing in several Asian countries during the Asian financial crisis of 1997-1998, the authors note:

...in many of these cases, controlling shareholders did not need to break any local laws in order to expropriate from investors. In most of these instances, management was able to transfer cash and other assets out of a company with outside investors, perhaps to pay the management's personal debts, to shore up another company with different shareholders, or to go straight into a foreign bank account. The fact that management in most emerging markets is also the controlling shareholder makes these transfers easier to achieve. (Johnson et al., 2000a, 143.)

Researchers describe similar instances in developed countries that are also not in violation of the law. For example, Johnson et al. (2000b) provide an example from France in which a minority shareholder unsuccessfully sued the controlling shareholder family for expropriating a corporate opportunity; the alleged expropriation involved having a family-owned company build and lease a warehouse to the public company.

¹² Of the 89 AAERs identified using the search words “related party” AND “fraud,” 8 used the term “related party” in the generic sense of parties related to a defendant, 12 contained inadequate detail on the role of a related party transaction, and the remaining 69 AAERs pertained to 34 different issuing companies. Several AAERs may be filed for actions related to a single company. We organize the actions by issuing company, and refer to each as a case.

misstatements and misappropriations. 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.

We categorize each case within this framework and include an alphabetized summary of AAERs as Appendix A. Through the use of qualitative descriptions, rather than summary statistics alone, we hope to provide the reader with a sense of the uniqueness of the cases examined. The descriptions primarily use the names of the companies and identify individuals by their title or role rather than by their names. Our primary interest is the role of related party transactions in enforcement actions, rather than the characteristics of the individuals and companies committing the violation or the resulting sanctions (although both aspects of enforcement actions potentially offer opportunities for further study.) Below, we describe how each type of transaction might potentially be used to misstate financial reports or to misappropriate assets and then illustrate with brief descriptions of example cases.

IV. The role of related party transactions in fraudulent financial reporting

Potential role of sales to (purchases from) related parties of goods and services to misstate financial reports or to misappropriate assets

Fictitious sales to a related party (including round-trip sales¹³) and/or mischaracterizing receipts as revenues overstate revenue. A corollary is that non-reported purchases from a related party understate expenses and thus overstate income. The opposites of these transactions (non-reported revenue and fictitious purchases on account) are conceivable but would understate income. While such outcomes are possible and might serve to smooth income, we presume in this framework that the use of related party transactions in fraudulent financial reporting aims to inflate reported income.

Genuine sales to a related party at below-market prices can transfer wealth to the related party. A corollary is that purchases from a related party of non-existent or unnecessary goods or services, or purchases at above-market prices can transfer wealth to the related party. Again, the opposites of such

Comment [e4]: We shift terminology here from "misappropriate assets" to "transfer wealth". Can the reader follow?

¹³ 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).

transactions (actual sales to a related party at above-market prices and actual purchases from a related party at below-market prices) are conceivable and would transfer wealth from the related party to the company. Such outcomes are possible and would serve some interest in shoring up an otherwise failing company,¹⁴ although the presumption is 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.

Instances from sample involving sales to (purchases from) related parties of goods and services

As shown in Table 1, Panel A, no cases in our sample specifically involved genuine sales of goods or services to related parties at below-market prices. Fictitious sales to a related party (including round-trip sales) and/or mischaracterizing receipts as revenues occur in 11 of the 48 cases. Apart from failing to disclose the related party feature, six of these cases involve improper accounting, four involve fictitious sales, and one involves both. Two companies' misstatements involving related party transactions are round-trip barter transactions.¹⁵ We provide brief descriptions of representative cases in this section and the sections that follow.

- Livent, Inc. (Livent) mischaracterized certain receipts as revenues, when in actuality, side agreements obligating the company to repay the funds meant that the receipts were actually borrowings. The counterparty-companies on these transactions were related parties because Livent's top executives served on their boards.
- Humatech, Inc. (Humatech) improperly recognized revenue for sales to a foreign distributor secretly controlled by the CEO and CFO, also without disclosing that they were related party transactions. The sales had been made contingent on the distributor reselling the product, which did not occur.

¹⁴ Such a transaction would serve the role of 'propping', i.e. where 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 create economic benefits to such transactions. See, for example, Friedman et al. (2003).

¹⁵ To the extent that they involve both a purchase and a sale, round-trip transactions could be categorized as both sales to and purchases from related parties. However, because the sole purpose of the purchase was to enable the recording of revenue from a corresponding sale, these two cases are categorized as sales.

- Almost all of C.E.C. Industries Corporation's (C.E.C.) revenue in one year (total \$1.2 million) was overstated because the company improperly recognized revenue in connection with a sale of land to a related party in exchange for a promissory note collateralized by its own stock.
- Swisher International Inc. (Swisher) sold a franchise to a company that was owned by its CEO, prematurely recognizing associated revenue of \$450 thousand in one quarter, and failed to disclose that it was a related party transaction. During another quarter, Swisher sold another franchise to a different senior officer and failed to disclose it was a related party transaction. Both of the undisclosed transactions allowed Swisher to report a profit rather than a loss for the applicable quarter.
- Ciro, Inc. (Ciro) reported fictitious sales and additionally improperly recognized revenue for franchise sales to its top executives. The SEC's action notes that "Ciro failed to disclose a series of related party transactions that enabled Ciro to improperly recognize revenue from purported franchise fees which were in fact disguised infusions of capital from [the company's chairman and its president and chief executive officer]."
- Softpoint, Inc. (Softpoint) reported fictitious sales to three foreign companies that were owned or controlled by the company's president and chairman.
- Itex Corporation (Itex), which managed a barter exchange and also served as principal in some barter transactions, allegedly obtained about half of its revenue in each of four years from sham barter deals with various offshore entities related to and/or controlled by the company's founder and control person.
- Netease.com, Inc. (Netease.com) recognized revenue for barter transactions that lacked economic substance. In one barter arrangement, NetEase.com sold advertising services to Company A and bought offsetting services from Company B. Both companies were related parties and no services were actually performed.

In our sample, no cases specifically involved non-reported purchases. Twelve cases involved purchases of services from related parties, which were variously unauthorized and/or undisclosed as being with a related party. In some cases, the related party transaction itself was integral to the violation (e.g. a service was fabricated to justify an improper payment to an executive). In others, the payments were not

alleged to have been improper per se, but rather were not disclosed as having been made to a related party. Examples follow.

- Chancellor Corporation (Chancellor) paid a \$3.3 million consulting fee to a company controlled by its CEO. The payment was not disclosed as a related party transaction and was also incorrectly capitalized rather than expensed, thus also overstating Chancellor's assets.
- Top management of Hollinger International (Hollinger) allegedly misappropriated the company's assets by arranging for the company to pay \$85 million to them and to a company they owned, purportedly for non-competition agreements.
- A kick-back scheme involved Livent paying inflated amounts to its vendors, and the vendors then kicking back money (\$7 million total) to Livent's Chairman/CEO and its President either directly or via a company which the Chairman/CEO controlled.
- Fictitious purchases of services from a related party were intended to conceal a misappropriation of PNF Industries, Inc.'s (PNF) assets by one of its principal owners. To conceal the misappropriation from the company's auditor, the individual claimed that he was owed consulting fees, created fictitious records in support of the fees, and fabricated minutes of a directors' meeting to authorize the fees.
- Enron paid around \$10 million in fees to one of its employees and its CFO to manage its special purpose entities (the Chewco and LJM entities); the employee shared a portion of his fees with the CFO via payments to members of the CFO's family.
- As part of a larger investigation, Tyco International (Tyco) was found to have failed to disclose a finder's fee paid to an outside director in connection with an acquisition.
- Madera International Inc.'s (Madera) failure to disclose consulting agreements with officers and directors, was only a minor part of the SEC's action which primarily pertained to a series of acquisitions of South American timber properties, which were improperly valued (in total at about \$52 million), either by reliance on unsupported appraisals or by valuing the property based on the company's securities issued in exchange for the properties.
- For Rite Aid, failure to disclose related party transactions was a small part of the SEC action, most of which describes how Rite Aid massively inflated income (by a total of \$2.3 billion) with activities not involving related party transactions. With respect to related party

transactions, Rite Aid misrepresented several transactions involving the CEO's interest in real estate leased by the company.

Potential role of asset sales to (purchases from) related parties to misstate financial reports or to misappropriate assets

Sales of assets to a related party at below-market prices, or purchases of non-existent assets or over-priced assets can transfer wealth to the related party. Over-valuing assets sold to related parties (more relevant in non-monetary exchanges, where there is no cash price benchmark) overstates reported gains. In purchases of assets, over-valuing the purchase inflates assets, but under-valuing the purchase could also serve to inflate future reported gains.

Comment [eg5]: I am not clear on what is meant by "genuine sales of asset (where cash is exchanged)" A sale can be genuine without the exchange of cash. Why not just say "Sales of assets for cash"?

Instances from sample involving asset sales to (purchases from) related parties

As shown in Table 1, Panel B, six cases involved sales of assets to related parties: one at a below-market price (Hollinger), one undisclosed (Tyco), and four seller-financed sales recorded at over-valued prices to inflate gains. Examples follow.

- The CEO and COO of Hollinger allegedly arranged for the company to sell various assets at below-market prices to another company they privately owned and controlled, "including the sale of one publication for \$1.00."
- Tyco allegedly made non-disclosed real estate sales to its CEO, but the SEC action did not indicate that the transaction was otherwise improper.
- MCA Financial Corporation (MCA) financed sales of allegedly over-valued assets to related parties in order to overstate its income, assets and equity. MCA purchased distressed rental properties which it then sold to related parties at inflated prices, recognizing gains on the sales.
- Many of the Enron related party transactions involved sales of assets to non-consolidated special purpose entities (the LJM entities *inter alia*) to report gains and/or avoid reporting losses. The sales typically did not transfer risk of ownership. To the extent that the assets were "warehoused" for later repurchase (Batson 2003), the Enron transactions also involved repurchasing the assets; however the only purpose of the repurchase was to facilitate the sale. Enron also sold certain assets to non-consolidated special purpose entities (the RADR

entities) in order to conceal Enron's corporate control of the assets and thus to qualify the assets for certain favorable regulatory treatment.¹⁶

Six cases involved purchases of assets from related parties, none of which under-valued the assets purchased. In one case (Tyco) the purchase price paid to the related party exceeded the market value, and in five other cases, purchases were recorded at inflated values. Examples follow.

- The SEC action against Tyco characterized the undisclosed purchase of real estate by the company from its CFO as occurring at a price "far more than its fair market value."
- Standard Oil and Exploration of Delaware, Inc (STDO) obtained oil and gas properties from another company that was majority-owned and wholly-controlled by two of its own officers. Because the company "acquired the property in a transaction resulting in the original owners of the properties controlling the registrant," the SEC determined that STDO should have reported the assets at their historical cost of \$578 thousand instead of reporting the value of the acquired properties as \$2.4 million and thus overstating its assets by over 300%.
- Great American Financial, Inc. (Great American) overstated the value of two assets acquired from officers of the company, reporting a value of \$225,000 for patents that did not exist and a value of \$1.1 million for a race horse. The SEC action states: "In fact, Great American never actually acquired any interest in the horse which had total lifetime race earnings of \$1,000, earned stud fees of less than \$1,000, and been recently purchased by the persons who contracted to sell it to Great American for only \$5,000."

Potential role of borrowings from (loans to) related parties to misstate financial reports or to misappropriate assets

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 loans to a related party are reported, over-estimating collectibility 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. Financing from a related party at below-market rates or off-market

¹⁶ The assets were wind farms, which qualified for financial benefits only if they were not more than fifty percent owned by an electric utility company. Since Enron was, at the time, acquiring an electric utility, they stood to lose the benefit (Batson 2003).

terms transfers wealth from the related party to the company, a practice referred to as “propping” (Freidman et al. 2003).

Instances from sample involving borrowings from (loans to) related parties

Table 1, Panel C lists nine cases involving borrowing from related parties, though none were identified as occurring at above market interest rates. Six of the cases involved borrowing from related parties, while the other three were instances of propping. Examples follow.

- Novaferon Labs, Inc.’s (Novaferon) CEO and directors controlled several companies that variously engaged with one another in lending, borrowing, asset sales, equity sales, and paying other’s expenses. The effects were to understate Novaferon’s liabilities and overstate its assets in filings related to its public equity offering. The SEC’s action noted that “Novaferon’s finances were not separable from the finances of four other entities which were under common control with Novaferon.”
- Adelphia Communications (Adelphia), by improperly netting \$1.351 billion related-party receivables against related-party payables, concealed \$1.348 billion of related-party payables. The netting also concealed the extent of the transactions between Adelphia and companies owned by the Rigas family (Adelphia’s controlling shareholder and management team). The SEC action states that Rigas family members fraudulently excluded “over \$2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia’s off-balance sheet, unconsolidated affiliates” and created “sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities.”
- Certain of Enron’s transactions (the Mahonia transactions) disguised \$2.6 billion of borrowing from a financial institution as forward contracts. In these transactions, Mahonia, a special purpose entity controlled by (i.e. related to) the financial institution was employed to achieve the disguise. The transaction structure was, roughly, circular movements of cash and commodity price risk. At inception of the disguised-loan, cash flowed from the financial institution to Mahonia and then to Enron; subsequently, payments that were in essence interest and principal flowed the other direction. The transactions were ostensibly forward commodity transactions, but the price risk passed in a circle -- from Enron to Mahonia to the financial institution and back to Enron – and thus played no economic role in the transaction. In other of its related party transactions, such as the fictitious asset sales and hedging (via the

LJM entities), Enron provided financing and/or guarantees directly or indirectly to the related entities.

- Refco’s use of related party transactions began when a company controlled by its Chairman and CEO assumed bad debts arising from customers’ trading losses. The CEO-controlled company was named Refco Group Holdings Inc. (“RGHI”). As a result, “Refco held a receivable from RGHI for hundreds of millions of dollars. Because [the Chairman and CEO] was an owner of Refco and controlled RGHI, the RGHI receivable was a related party transaction for Refco.” To conceal these related party receivables at each fiscal year-end, the company engaged in a circular borrowing/lending scheme with a bank. Refco would deposit funds with (i.e. lend to) the bank; in turn, the bank would lend to RGHI; and in turn, RGHI would send funds to Refco to pay off the receivables. As a result, Refco’s financial reports would reflect a deposit with the bank instead of the related party receivables. The bank’s financial reports would reflect a deposit from Refco and a loan to RGHI. After the end of each fiscal year-end, the transactions would be reversed.
- Pantheon Industries, Inc.’s (Pantheon) violation was that the company reported \$40 million of forged notes receivable from a foreign bank as assets. In this example of propping, two of the company’s executives had purchased the fraudulent note with \$100,000 of their personal funds and payables issued by other companies they owned.
- Endotronic’s co-founders and top executives fraudulently recorded receipt of a \$3.4 million note receivable as revenue when no sale had occurred and the company had agreed to return the note. The role of related party transactions was to provide funding to the company as follows. The founders “used their Endotronic stock as collateral for personal loans, the proceeds of which were secretly channeled to a third party financing company to purchase Endotronic’s accounts receivable.”

Overall, providing financing to related parties was the most frequent type of transaction in the enforcement actions. In addition to the cases involving mischaracterization of both borrowing from and lending to related parties, these cases involved unauthorized and/or un-disclosed loans by companies directly to its executives;¹⁷ loans to companies controlled by its executives; mischaracterized loans; mis-valued loans to related companies; misappropriations of funds disguised as loans; and otherwise improper related party financing. Several cases involved multiple loan related misstatements. Examples follow.

¹⁷ Sarbanes-Oxley no longer permits loans to executives.

- In addition to the improperly netted \$1.351 billion related-party receivables from entities owned by its controlling shareholders (discussed above), Adelpia also was co-borrower with the controlling shareholders' other companies on a \$3.7 billion credit facility. Adelpia's role as co-borrower, though not a loan to the related parties, facilitated the related parties' borrowing. By failing to correctly report its own obligation under the credit facility – claiming its obligation was merely a guarantee not requiring disclosure – Adelpia understated its liabilities by a further \$1.6 billion.
- Top executives at Tyco improperly granted themselves loans from the company at zero or low interest rates, used the proceeds for personal expenses, and covertly arranged for some of the loans to be forgiven.
- Among Rite Aid's undisclosed real estate transactions with its CEO, the company funded the CEO's purchase – via a partnership controlled by the CEO and a relative – of a site that the company was considering for a store location and had then paid over \$1 million for improvements to the site, despite the fact that the site was owned by the CEO.
- Puryear Realty Resources (Puryear) used proceeds of an equity offering to make loans to companies in which Puryear's founder (also president and chairman) had financial interests. The largest amount in notes receivable was due from a company in which Puryear's founder (also president and chairman) had a 10% ownership and served as chief financial officer and which was controlled by his ex-wife. The largest amount in loans receivable was due from a company for which Puryear's founder (also president and chairman) was President.
- As discussed above, MCA sold over-valued properties to related parties and also provided financing to the related parties, partly with receivables and partly with mortgages. Per the SEC, all of these financial assets carried on MCA's balance sheet were reported at inflated values; specifically, despite the related parties' inability to repay, MCA reported the related party receivables with no valuation allowance and the related party mortgages with inadequate loan loss provisions.
- The CEO (who was also chairman and majority shareholder) of The Cronos Group (Cronos) misappropriated funds through related party borrowing. The company made disbursements of over \$7.5 million directly to the CEO or indirectly to other companies he owned. The amounts were reported as unsecured loans, with no disclosure of the relationship between the CEO and the debtor-company.
- PrintontheNet.com failed to disclose that it had guaranteed \$7.3 million in related parties' loans, most of which were in default.

- Related party receivables were only a small part of the SEC’s action against General Technologies Ltd. (General Technologies). Most of the action pertained to misreporting not involving related party transactions, resulting in reporting pre-tax income during three fiscal years of over \$2 million when in fact the company lost over \$12.5 million. Regarding related parties, the SEC’s action refers to “receivables for five related parties,” but provides no background on their origin.

Potential role of investments in (sales of equity to) related parties to misstate financial reports or to misappropriate assets

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 transfer wealth to the related party.

Instances in sample of investments in (sales of equity to) related parties

Only one of the cases in our sample involved an executive investing in the equity of a related party as a means of misappropriating assets. The other instances of investments in related parties include one where a company failed to disclose an equity investment in an entity with which its top executives were affiliated, one where an ownership structure was used to circumvent an individual-specific regulatory constraint, and four where incorrectly identifying an ownership structure resulted in overstatement of assets and/or regulatory capital. Examples follow.

- The CFO of Tonka misappropriated assets by causing corporate funds improperly to be invested in a company he secretly owned.
- Hollinger’s CEO authorized the company to invest \$2.5 million in a venture capital fund with which he and other top executives were affiliated. The investment was not disclosed.
- In the case of Altratech, Inc., an individual had been barred from bidding on municipal works contracts in New York City because of previous criminal activity, so he created a corporate structure to circumvent the ban.
- One of the cases in which related party transactions inflated statutory capital was Dixie National Corporation (Dixie). This insurance company did not disclose intercompany

transactions (i.e., related party transactions) that had served to inflate its statutory capital and surplus above the minimum amounts required by state regulations.

- Another case in which related party transactions inflated statutory capital was Transmark USA, Inc. (Transmark). The company inflated the statutory capital and surplus of its primary subsidiary (GSL, a life insurance company) by 60% to 170% over five years using two techniques – one involving related party transactions and the other involving round-trip security trades that straddled the fiscal year end. By inflating the statutory capital, the subsidiary circumvented restrictions on writing new insurance policies and on paying dividends to the parent company. The related party transactions involved two stages. First, Transmark restructured its ownership in other, non-insurance subsidiaries so that it controlled those subsidiaries through: (a) options and warrants rather than common stock (the common stock was held by shell corporations); and (b) agreements that allowed Transmark to direct the actions of the subsidiary. Having restructured its ownership, Transmark improperly claimed these non-insurance subsidiaries were not “related corporations” of GSL. In the second stage, transactions among the subsidiaries were used to falsely enhance the company’s financial position. In one example, funds traveled in a circle: GSL extended loans to the non-insurance subsidiaries, which then paid dividends to Transmark, who then made a capital contribution into GSL. The result of the transactions was that GSL inflated its assets by including the receivables from the related companies in its asset base.
- Pacific Waste Management, Inc. (Pacific Waste) purchased, in an exchange of stock, an interest in another company owned by its president (who was also a director and the controlling shareholder). The investment represented 98% of Pacific Waste’s assets. The value of the investment was improperly based on the securities issued to obtain the investment rather than on the historical cost basis. The purpose was to inflate the assets of Pacific Waste so that the company’s stock would not be a “designated security.”¹⁸
- PNF misidentified which of its two predecessor companies was the acquirer in a business combination. The company allegedly improperly revalued patents in the process of effecting the combination of PNF’s predecessor companies (Portafone and No Fire). The resulting overstatement of the company’s assets and shareholders’ equity enabled the company to qualify for a stock exchange listing. Though not termed as such in the SEC action, the

¹⁸ A designated security is one subject to securities laws designed to restrict “high-pressure sales tactics by broker/dealers involving certain speculative, low-priced securities traded over the counter.” See <http://nasd.complinet.com>. Location: NASD > Notices to Members > 1993 > 93-55 SEC Amends and Clarifies Penny Stock Rules.

business combination itself was a related party transaction since a single individual was the controlling shareholder of both Portafone and No Fire.

With respect to sales of equity stakes to related parties, the cases varied. In one, a related party was not identified as an owner and subsequent seller of the company's equity. In another, a company failed to disclose its stock issuance as a related party transaction. In two other cases, related parties obtained ownership stakes at off-market prices.

- Swisher registered securities for sale and failed to disclose that its CEO was the beneficial owner of the securities (through a Bahamian company).
- Softpoint, Inc. issued common stock to its executives that more than doubled the company's then-outstanding shares, which the SEC cited as "an out of the ordinary business compensation arrangement with related parties."
- International Teledata's executives caused shares to be issued to themselves for no consideration.
- In the case of Enron (JEDI, Chewco, LJM), certain executives obtained ownership stakes with guaranteed substantial returns for assuming little or no risk (i.e., ownership at an off-market prices).

Deleted: '

In summary, although numerous examples of abusive related party transactions are listed, a pattern emerges. Specifically, while over 76 different examples of related party transactions related to misstatements and misappropriations for the 48 companies have been discussed, it is interesting to note that six companies (Adelphia (5), Enron (5), ESM (3) Hollinger (3), Rite Aid (3), and Tyco (4)) provided roughly one-third of the examples.

V. Aspects of auditing related party transactions found deficient in SEC enforcement actions

Challenges exist with respect to the identification, examination, and disclosure of related party transactions (AICPA 2001). These activities are sequential (i.e., path dependent). A related party transaction must first be identified in order to be examined or disclosed. Once identified, a related party transaction must be adequately examined in order to ensure proper disclosure. Thus, if a related party transaction is not identified, it will not be possible to examine it or ensure proper disclosure. If a related party transaction is identified, but not adequately examined, it will not be possible to ensure proper

disclosure. In this section, we document comments from SEC enforcement actions that suggest at which point the audit of related party transactions was found to be deficient. For those cases where an action against the auditor was identified, Table 2 categorizes each according to the aspect of auditing related party transactions apparently found to be deficient.

For 31 of the 48 SEC enforcement cases examined in this study, including the 12 companies in Beasley et al. (2000), actions against the auditors are identified.¹⁹ As noted in Beasley et al. (2000), failed audits typically exhibit several deficiencies. Here, our focus is only on the deficiencies specifically concerning auditing related party transactions.²⁰

Identification of related parties and related party transactions

In six cases, each of which is described below, the audits appear to have failed at the point of identification:

- In the case of International Teledata, the SEC action against the auditors cites failure to identify the related party transactions. The auditors knew shares had been issued (the issuance was footnoted in the financial statements), and if they had reviewed the board minutes, they would have known the issuance had not been approved by the board. Also, the SEC action indicates that if the auditors had made inquiries to determine to whom the shares were being issued, they would have discovered that – in addition to not being authorized by the board – most of the stock issued “went to related parties in exchange for inadequate consideration.”
- For Pacific Waste, although the auditor claimed that management had represented that there were no related party transactions, the SEC’s action noted that there were at least five documents in the auditors’ files showing that the company’s president and controlling shareholder was also an officer, director and controlling shareholder of the investee-company used to effect the misstatement.
- In the Softpoint case, the auditor used the client’s fax machine and a fax number provided by the client. The inference is that had the auditor independently verified the fax numbers, he

¹⁹ Enforcement actions against the auditors were identified by searching the AAER database for the company name.

²⁰ The AAERs includes only minimal reference to related party transaction audit deficiencies for three cases (C.E.C.; Dixie; Oiltech).

would have identified the fictitious sales to three companies owned by Softpoint's president and chairman.

- In the case of Pantheon, the auditor used the fax number provided even though the SEC action notes that the number differed from that shown in the banking directory located in the audit files. The inference is that had the auditor independently verified the fax numbers, he would have identified the forged notes which had been purchased with private funding from Pantheon's top executives.
- The SEC's action against the auditor of STDO states that the auditor "...failed to maintain any attitude of professional skepticism, frequently substituting STDO's management judgment for his own. For example, STDO management drafted [the auditor's] audit reports and on at least one occasion [the auditor] simply provided his blank, signed letterhead to STDO for preparation of his audit report."
- In the case of Tri-Comp Sensors, the auditors knew of the loans, but did not require disclosure because they believed the counterparties to the transactions were unrelated to Sensors. However, the SEC action cites various red flags that should have indicated the transactions were with related parties. With respect to one of the larger loans directly to a subsidiary of the holding company controlled by Sensors' CEO, among the red flags were the following: "(1) the loan was a large isolated transaction made immediately upon the closing of Sensors' initial public offering and constituting almost a quarter of the net offering proceeds; (2) no interest was paid on the loan; and (3) there was no written agreement or record documenting the loan terms or purpose."

Examination of related party transactions

We classify enforcement actions against auditors as an audit failure at the examination stage if it is stated in the enforcement action that the auditor knew of related party transaction or if it can be inferred from the case that the auditor must have known of the related party transaction. Of the 31 enforcement actions against the auditors, 16 involve the auditor's examination of the related party transactions. In two cases (Novaferon and Atratech), identification of the related party transactions was unavoidable however the auditor did not perform any audit procedures on the related party transactions. In three cases (Chancellor, Cronos, and PNF), the audit failures related to the inadequate examination of fees or other disbursements to top executives. For the first two of these cases, it can be inferred that identification was

not the problem because the SEC actions specifically mentions predecessor auditors' actions highlighting the existence of the payments. On the third case (PNF) the enforcement notes that the auditor inquired about the transaction but did not perform additional audit procedures. Nine transactions involved inadequacies with respect to valuing assets obtained in related party transactions (Great American and Itex) and related party receivables/loans (MCA, Puryear Realty, General Tech, BBS, Convenient Food Mart, ESM and First Humanics). In one case (Flight Transportation), the SEC action notes that the auditor knew the transactions were with related parties, but failed to properly examine them. Finally, in one case (Cascade), the SEC specifically cites failure to properly examine related party transactions, but does not identify the transactions or parties. Examples follow.

- The SEC's action against the auditor noted that "Novaferon's finances were not separable from the finances of four other entities which were under common control with Novaferon." The SEC's action also noted that the company "maintained virtually no normal business or accounting records susceptible of audit. The company's books consisted primarily of a check register." Despite the deficiencies in the company's accounting, the auditor relied on management's representations and notations in the checkbook rather than obtaining audit evidence from third parties. "He prepared or retained few work papers, did not assess internal accounting controls and did not prepare any written audit program or description of his work."
- In the case of Atratech, the top executive instructed his auditor to "recast the book entries for transactions between two subsidiaries from 'related party receivables' to 'accounts receivables' as part of concealing the relationship. Among the SEC's other allegations against the auditor were that he knew that the financial statements could not have been prepared in accordance with GAAP because the intermingled accounting records of the different companies within the corporate structure made it impossible to separately reconcile the accounts.
- In the audit of Chancellor, the deficiency was that the auditor "failed to obtain sufficient evidential matter to support recording the... fee [paid to its CEO for merger-related consulting], particularly evidence sufficient to understand the purpose, nature, extent and financial statement effect of this related-party transaction." The SEC action specifically mentions the company's predecessor auditors' draft management letter raising the issue of lack of documentation for related-party transactions.

- Cronos was another case where predecessor auditors identified problems with disbursements to the top executive. The SEC’s action against Cronos’s successor auditors for, *inter alia*, failing to examine related party transactions stated that the predecessor audit firm had resigned when “it failed to receive sufficient competent audit evidence to support a \$1.5 million disbursement by the company, was denied access to the results of a corporate investigation involving other related party transactions, and Cronos’ board refused to investigate the \$1.5 million payment, forged and false confirmations, and other related party transactions.”
- The auditor of PNF Industries had identified payments to a control person, questioned the payments, but was given fictitious supporting records, including fabricated board meeting minutes. The records contained inconsistencies proving that they were fictitious, including references to information that was not known until months after the date on the records. The SEC action stated: “Because this was a material related party transaction involving ... a convicted felon, [...the auditor] should have closely scrutinized the evidence supporting [the individual’s] expenses. Nevertheless, [...the auditor] failed to review the evidence obtained and therefore failed to consider whether the minutes had been fabricated.”
- The auditor of Great American was cited for having inappropriately relied on management’s representations about the value of a fictitious patent and an over-valued race horse, both acquired from officers of the company.
- The auditor of Itex was cited for failure to exercise professional skepticism concerning the value of bartered assets, some or all of which had been obtained from deals with entities related to and/or controlled by the company’s control person. The Itex failure occurred despite a number of red flags about both the transactions and the asset appraisals. An example red flag relating to the transactions was “... certain significant transactions occurred at or near the end of fiscal periods, involved unusual purchases, sales, and repurchases of assets within a short period of time, and a series of transactions involving an offshore entity whose sole address was a post office box in Belize, Central America.” An example red flag relating to the appraisals was that many of the appraisals gave the same value to numerous pieces of artwork, for example 14 paintings with an appraised barter value of \$62,500 each and 29 sculptures with an appraised barter value of \$110,000 each.
- For MCA Financial, the SEC action described two main ways that the auditing of these receivables was inadequate. First, the auditors could have reviewed the financial statements of the related party and concluded that the receivables could not be repaid from the related party’s cash flow. Second, to assess whether the receivables could be repaid by liquidating

the underlying collateral (most of which had been acquired from MCA), the auditors relied on “estimated fair market values provided by management” and also on “property appraisals performed by the brother-in-law of MCA's CEO while employed by a company that the auditors listed as an MCA subsidiary.” Further, the auditor had specifically noted in the workpapers that this appraiser was a "Related Entity."

- For Puryear Realty the SEC's action against the auditor noted that: "...despite the concerns resulting from Puryear Realty's lack of internal controls...[namely that the company's accounting department consisted of one person, with no separation of responsibilities]...and the materiality of these receivables, [the auditor] obtained no confirmations for some receivables and for other receivables received confirmations from affiliates signed, in various capacities, by [the company's founder] or his ex-wife."
- With respect to General Tech's audit deficiencies, the SEC's action noted that all of the company's "accounts receivables appeared on computer-generated aged receivable listings, except for the receivables for five related parties that were simply handwritten in at the bottom of those computer listings. Despite the manner in which those five were recorded, [the] audit staff did not perform any audit work with respect to them."

Disclosure of related party transactions

Of the 31 enforcement actions against auditors, we identify six cases that we classify as failure to ensure adequate disclosure. In these six cases there appears to be little doubt about the auditors' identification of the related party transactions, and little likelihood that the auditor inadequately examined the transactions. Examples follow:

- Madera failed to disclose consulting agreements with officers and directors. The SEC action states that the auditors were aware of the consulting agreements, copies of which were in the audit files, and knew that the company had issued stock to the consultants. The transactions were identified as related party transactions in the audit plan. In addition, the audit manager noted on a comment sheet based on his review of Madera's Form 10K, "disclose consulting fees as related party transactions."
- For Transmark, the auditor "testified that he knew that Transmark engaged in the restructurings in order to make GSL's affiliates appear to be non-related corporations for purposes of GSL's calculation of its admitted assets." Although the subsidiaries were consolidated in Transmark's GAAP financial statements, the auditor "permitted a 'form over substance' treatment for statutory accounting purposes... and placed undue reliance upon a

purported interpretation of the statute by Transmark's in-house legal counsel on this significant transaction that materially affected the solvency of GSL.”

- In the action against Tyco’s auditor, the SEC cited repeated instances which should have alerted the auditor to the executive team’s lack of integrity, including: (i) they did not voluntarily inform the auditors about a related party transaction (a finders fee to an outside director); (ii) they repeatedly accounted for certain executive bonuses in a way designed to keep the expenses from affecting operating expenses; and (iii) they regularly failed to properly disclose the existence of the bonuses in SEC filings, as either compensation or as related party transactions. The SEC action specifically references auditing standards that “one example of a reportable condition [one that represents significant weakness in internal controls and thus should be communicated to the audit committee] is ‘evidence of significant or extensive undisclosed related party transactions.’”
- Finally, the SEC’s action against Adelphia’s auditors raised numerous disclosure deficiencies. First, Adelphia was jointly and severally liable for co-borrowings with a related party (the Rigas family) and thus should have reported the liability. The SEC action notes that during the audit, the auditor “repeatedly proposed disclosure of the full amount of the Co-Borrowing debt. [The auditor] inserted more explicit disclosure, including the amount of Rigas Co-Borrowing debt, in at least six drafts of Adelphia's 2000 Form 10-K. But when Adelphia's management resisted, [the auditor] abandoned its attempts to make the disclosure more accurate.” A second disclosure deficiency was the improper netting of related party receivables and payables. Adelphia netted \$1.351 billion related-party receivables against \$1.348 related –party payables to show only \$3 million net receivables; the netting practice concealed the extent of related party transactions between the company and the Rigas family and was characterized by the SEC as “a fraudulent device used to conceal its liabilities.” The SEC action against the auditor states that “Adelphia was required both by GAAP and by Commission regulations to report related party transactions with the Rigas Entities in a gross presentation.” A third disclosure deficiency was broader. The SEC action against the auditors noted that Adelphia and the related-party companies shared a cash management system (CMS) and “the general ledger recorded the thousands of intercompany transactions among and between Adelphia subsidiaries and Rigas Entities. A review of bank statements would have shown that cash receipts for both public and private entities were deposited into Adelphia's First Union CMS account and that disbursements on behalf of public and private entities were paid from that same account.” However, the disclosures of related party transactions required under FAS 57 were inadequate.

Actions against the company or executives that cite concealment from auditors

In a number of cases, the SEC's action against the company or its executives cites specific instances of behavior to conceal information from the auditors. For example, in an action against executives of Enron Broadband Services (EBS) for a sham monetization transaction (known as Project Braveheart) designed to inflate earnings by \$111 million, the SEC complaint alleges that the executives "intentionally misled Enron's auditor [Arthur Andersen] about the true character of the Braveheart transaction because they believed that Andersen would not approve of the transaction or allow EBS to record any revenues had Andersen known the truth." In another action against J.P. Morgan Chase & Co. (Chase) for its role in disguising \$2.6 billion of Enron's borrowing as forward contracts, the SEC complaint alleges that Chase helped Enron conceal the true characteristics of the transactions from Andersen.²¹ As another example, the SEC's complaint against Rite Aid's top executives states they provided their auditors with management representation letters containing numerous false statements, including "Related party transactions have been properly recorded or disclosed in the financial statements."

VI. Conclusions and implications for future research

In this study, we document the role of related party transactions in sample of 48 SEC AAER cases involving such transactions, categorized according to the following framework: (1) sales to (purchases from) related parties of goods and services; (2) asset sales to (purchases from) related parties; (3) borrowings from (loans to) related parties; and (4) investments in (sales of equity to) related parties. The most frequent type of transactions in the enforcement actions were: loans to related parties; payments to company officers for services that were either unapproved or non-existent; and sales of goods or services to related entities in which the existence of the relationship was not disclosed. Though perhaps self-evident, it nonetheless bears highlighting: misappropriation of the company's assets are most often

²¹ In June, 2002, Arthur Andersen, the auditors of Enron, were found guilty of obstructing justice by destroying documents related to the Enron audit (*Washington Post* 2002). In June, 2005, the Supreme Court overturned the 2002 conviction (*Washington Post* 2005a). In November, 2005, the Justice Department abandoned its case against Arthur Andersen (*Washington Post* 2005b).

related to transactions where the cash flow is outward, while instances of fraudulent financial reporting are more often related to transactions where the cash flow is expected to be inward.

In some of the cases we examine, related party transactions were central to the fraud. For example, we document misstatements achieved by undertaking fictitious sales to a related party and misappropriations achieved by unauthorized and/or undisclosed payments to a related party for services. In other cases, the related party transactions were more peripheral. For example, the major misstatement was achieved with no involvement of a related party transaction, e.g. by inflating inventory to understate cost of goods sold.

The number of enforcement actions specifically involving related party transactions and fraud is a comparatively small proportion of the approximately 2,500 total AAERs. While admittedly not a definitely exhaustive count (due to variations in terminology for describing related party transactions), this count is suggestive of a relative infrequency of the co-occurrence of related party transactions and fraud which is consistent with prior empirical research (Shapiro 1984; Bonner 1998; SEC 2003). These findings are also consistent with evidence that the occurrence of related party transactions is about the same in fraud and non-fraud cases (Bell and Carcello 2000). In addition, as we have noted, since disclosed related party transactions are common (Gordon et al. 2004a) while fraudulent financial reporting is relatively uncommon, it is reasonable to assume that most related party transactions are not fraudulent. Overall, research is inconsistent with the public (and professional) perception that related party transactions are usually fraudulent. To the extent that such a perception exists, it is probably due to the high profile nature of recent frauds that involved related party transactions and thus may reflect an “illusory correlation,” i.e. when one perceives a causal relationship, one tends to think that co-occurrence is more frequent than it actually may be.

Comment [e6]: As evidence of public perception that RPTs are undesirable, we could refer to the NYSE's former requirement that companies stop doing any RPT after listing.

For 31 of the cases in which an AAER cited auditor failure regarding the auditing of related party transactions, we find that the majority of audits fail at the examination stage rather than at identification or disclosure stages of the audit process. This finding indicates that auditors might benefit from additional guidance on appropriate audit procedures for examining transactions with related parties.

Misstatements and misappropriation can be achieved with or without related party transactions. Further research might address the costs and benefits of using a related party transaction to a potential fraud perpetrator. Using an unrelated third party for misstatement or misappropriation can serve to disguise the transaction, but increases the complexity from the perspective of the executive who must negotiate sharing arrangements with the third party. Using a related party might reduce the complexity of negotiating sharing arrangements but would also reduce some of the potential benefits of concealing the transaction. The trade off of the cost of complexity against the benefit of disguising the transaction is a function of the relative power of the individual within the company, the internal controls and corporate governance of the company, and the abilities of the external auditor.

Overall, our study indicates that related party transactions are not necessary as mechanisms for fraud, and their presence need not indicate fraudulent financial reporting. An implication is that it is important for the auditing profession to understand the benign nature of most related party transactions, the differentiating features between benign and fraudulent transactions, and the importance of evaluating a company's related party transactions in light of its broader corporate governance structure. For instance, a company that engages in related party transactions faces governance challenges (Kohlbeck and Mayhew 2004; Gordon et al. 2004b), and such challenges themselves warrant awareness of potential for fraud. Additionally, it may not be important for regulators to place disproportionate emphasis on all aspects of auditing related party transactions if the risk of misstatement associated with such transactions is not uniformly excessive.

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Appendix A

Annotated list of SEC Enforcement actions involving Related Party Transactions

*Indicates a case where the audit failure was analyzed by Beasley et al. (2001)

Adelphia Communications Corporation

AAER Nos. 2325-2326. September 30, 2005; AAER Nos. 2236-2237, April 26, 2005; AAER No. 1599, July 24, 2002. The complaint alleges that the company understated its liabilities by \$1.6 billion by improperly excluding its portion of co-borrowings with entities controlled by the family that were also the controlling shareholders of Adelphia (the Rigas family). In addition, the company improperly netted \$1.351 billion related-party receivables against \$1.348 related –party payables to show only \$3 million net receivables; the netting practice concealed the extent of related party transactions between the company and the Rigas family and was characterized by the SEC as “a fraudulent device used to conceal its liabilities.” Further, the complaint alleges that the Rigases fraudulently excluded “over \$ 2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia's off-balance sheet, unconsolidated affiliates” and created “sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities.” Apart from the financing provided to companies controlled by its own controlling shareholders, Adelphia also engaged in and concealed its extensive self-dealing with Rigas family members. Such transactions included using company funds to finance the family's purchases of stock, to pay off personal margin loans and other debt, and to purchase various real estate for the family.

***Altratech, Inc.**

AAER No.. 613. September 30, 1994.

Testimony Concerning The Involvement of Organized Crime on Wall Street by Richard H. Walker Director, Division of Enforcement U.S. Securities & Exchange Commission. Before the House Subcommittee on Finance and Hazardous Materials, Committee on Commerce. September 13, 2000. Retrieved from: <http://www.sec.gov/news/testimony/ts142000.htm>.

An individual had been barred from bidding on municipal works contracts in New York City because of previous criminal activity, so he created a corporate structure to circumvent the bars. Per SEC allegations, he instructed his auditor to “recast the book entries for transactions between two subsidiaries from ‘related party receivables’ to ‘accounts receivables’ as part of concealing the relationship.

Bevill Bresler & Schulman, Incorporated (BBS)

AAER No. 384. MAY 21, 1992. BBS made material related party loans. The loans, in the form of securities reverse repurchase agreements, were with a company owned -- via a holding company -- by the same individuals that owned BBS.

***Cascade International, Inc.**

AAER No. 656. March 14, 1995; AAER No.. 770. March 29, 1996. The complaint alleges that the company's top managers (five individuals) inflated the number of retail outlets operated by the company and overstated assets and revenues by 50%. Having issued the misleading information, the managers sold around \$7 million of the company's stock. Interestingly, from a governance perspective, the SEC document notes that two of the board members were married and that the independent board member was the dentist and long-time friend of the company's chairman. The SEC enforcement action against the auditor cites various departures from GAAS including failure to “properly examine transactions with related parties,” but does not identify the transactions or the parties.

C.E.C. Industries Corporation.

AAER No. 1220. February 7, 2000. The complaint alleges that almost all of the company's revenue in one year (total \$1.2 million) was overstated because the company improperly recognized revenue in connection with a sale of land to a related party in exchange for a promissory note collateralized by its own stock that was owned by the related party. "CEC received no cash down payment and had no reasonable basis to believe the related party was able to pay for the land." In subsequent years, the company's misreporting did not involve related party transactions. The company overstated assets (including artwork, land, and common stock) that had been acquired in non-cash exchanges, i.e. for CEC stock or vacant land.

Chancellor Corporation

AAER No. 2363, January 13, 2006; AAER No. 2229-2230, April 11, 2005; AAER No. 1762-1764, April 24, 2003. The complaint alleges that the company recorded an acquisition in the fiscal year prior to its actual closing. Also, in connection with the acquisition, the company paid a \$3.3 million consulting fee to Vestex, a company controlled by its CEO. The payment was not disclosed as a related party transaction and was also incorrectly capitalized rather than expensed, thus further overstating the company's assets.

Ciro, Inc.

AAER No. 612. September 30, 1994. The complaint primarily involves the company's overstating revenue from fictitious sales, failing to record expenses, and understating cost of goods sold by falsifying inventory. In addition, "Ciro failed to disclose a series of related party transactions that enabled Ciro to improperly recognize revenue from purported franchise fees which were in fact disguised infusions of capital from ... Ciro's chairman of the board and ... Ciro's president and chief executive officer."

The Cronos Group

AAER No. 1208. November 15, 1999. The complaint alleges that the CEO (who was also chairman and majority shareholder) misappropriated funds using other companies which he owned. Cronos disbursed over \$7.5 million directly and indirectly to its CEO, and reported the amounts as unsecured loans to another company he also owned. The funds were allegedly used by the CEO to pay personal expenses. The relationship between the CEO and the debtor company was not properly disclosed in the company's IPO documents. The SEC's action against the company notes that under pressure from its auditors, the CEO subsequently guaranteed the loans and provided collateral. Later, when the auditors learned that the CEO had provided a forged letter from a bank stating that certain funds had been repaid, they resigned from the audit.

Convenient Food Mart, Inc.

AAER No. 465. July 13, 1993. Following an extensive expansion of its business, the company's accounting system was unable to properly track intercompany (i.e. related party) transactions such that an out of balance situation in its company-wide intercompany accounts grew to approximately \$4.1 million. In its subsequent restatement, the company's previously reported pre tax income of \$4.4 million became a loss of \$9.3 million.

***Dixie National Corporation.**

AAER No. 535. March 9, 1994. The complaint alleges that this insurance company did not disclose intercompany, i.e. related party transactions that had served to inflate its statutory capital and surplus above the minimum amounts required by state regulations.

Enron Corp.

(Partial AAER listing). AAER No. 1640. October 2, 2002. AAER No. 1738. March 12, 2003. AAER No. 1771. May 1, 2003. AAER No. 1894. October 9, 2003. AAER No. 1942. January 14, 2004. AAER No. 1947. January 22, 2004. AAER No. 1959. February 19, 2004. AAER No. 2051. July 8, 2004. The complaints allege that the company fraudulently manufactured earnings and concealed debt and losses by

variously: manipulating asset values, entering into sham transactions through and with related entities, reorganizing segments to conceal loss-making entities within profitable segments, manipulating expenses and creating and using special reserves. In addition, the CFO earned over \$30 million from undisclosed investments in the company's special purpose entities.

AAER No. 1820. SEC complaint available at: <http://www.sec.gov/litigation/complaints/comp18252.htm>. The complaint alleges that J.P. Morgan Chase assisted Enron in manipulating its financial results by disguising about \$2.6 billion of loans as commodity futures contracts (the Mahonia transactions.)

Civil Action No. H-03-0905 available at <http://www.sec.gov/litigation/complaints/comp18122.htm>. The complaint alleges that executives of Enron Broadband Services undertook sham transactions to fraudulently inflate earnings by \$111 million. (known as "Project Braveheart").

Related party transactions played a significant role in Enron's fraudulent financial reporting. Regarding related party transactions, the bankruptcy examiner for Enron wrote (Batson 2003, 1 and 6):

The most important purpose for and effect of the Related Party Transactions was the enormous increase in Enron's reported GAAP income for these periods. As a result of the Related Party Transactions, Enron (1) overstated its income by approximately \$1.5 billion from 1997 through June 30, 2001, (2) overstated its equity by \$1.5 billion at December 31, 2000 and \$1.9 billion at June 30, 2001 and (3) understated its indebtedness by \$885 million at December 31, 1999....The Related Party Transactions, including most notably the hedging transactions, had no valid business purpose from Enron's perspective other than to achieve desired financial statement reporting.

ESM Government Securities, Inc. (ESM)

AAER No. 118. October 16, 1986. The complaint alleges that the company had extensive borrowing and lending (around \$300 million) with its parent company in the form of securities repurchase and reverse repurchase agreements. The purpose of the transactions was to hide ESM's significant losses. In addition, another company within the group, despite its insolvency, made personal loans to individual executives of the group (around \$38 million).

First Humanics Corp.

AAER No. 717. September 26, 1995. The complaint alleges that the company's undisclosed control person and undisclosed promoter of its securities received acquisition fees of \$100,000 to \$300,000 for arranging the purchases of each of 21 nursing homes acquired by the company. Subsequently, when the company experienced financial problems, the control person began contributing acquisition fees to the company.

Flight Transportation Corporation ("Flight").

AAER No. 81. December 5, 1985. The complaint alleges that the president and other top executives engaged in a scheme to inflate the revenues, profits and assets of the company in various ways, including over \$18 million in fictitious sales to companies secretly owned by Flight's president (90% of total sales and 147% of net income, in one year and 53% of sales and 51% of pre-tax profits in a subsequent year).

G.C. Technologies, Inc. (G.C. Tech.)

AAER No. 285. December 4, 1990. The complaint alleges that mining leases and oil well leases were obtained by an individual who then arranged for the assets to be sold at inflated prices between and among companies he controlled, including G. C. Tech. As a result of these undisclosed related party asset sales, G. C. Tech substantially inflated the value of its reported assets.

***General Technologies Group Ltd.**

AAER No. 688. July 24, 1995. The complaint alleges that over a three year period, the company overstated inventory (by quadrupling the value of the labor per part), receivables, revenues and understated payables, reporting a pre-tax income of over \$2 million when in fact the company lost over \$12.5 million. The company's senior managers both beneficially owned more than 5% of the company's outstanding common stock, although they did not file the required SEC ownership forms. With respect to related party transactions, the SEC's action noted: "All of General Tech's accounts receivables appeared on computer-generated aged receivable listings, except for the receivables for five related parties that were simply handwritten in at the bottom of those computer listings. Despite the manner in which those five were recorded, [the] audit staff did not perform any audit work with respect to them."

Great American Financial, Inc.

AAER No. 46. December 24, 1984. The complaint alleges that the company overstated the value of two assets acquired from officers of the company, reporting a value of \$225,000 for patents that did not exist and a value of \$1.1 million for a race horse. The SEC action states: "In fact, Great American never actually acquired any interest in the horse which had total lifetime race earnings of \$1,000, earned stud fees of less than \$1,000, and been recently purchased by the persons who contracted to sell it to Great American for only \$5,000."

Humatech, Inc.

AAER No. 2193. March 1, 2005. The complaint alleges that the company improperly recognized revenue for sales to a foreign distributor secretly controlled by the CEO and CFO, thus overstating its revenues and accounts receivable. The company did not disclose in its SEC filings that the sales were related party transactions. Further, the sales had been made contingent on the distributor reselling the product, which did not occur. When the company restated its financial statements and eliminated the revenue and assets for these transactions, the SEC action states that the "amended filings falsely stated that an epidemic of foot-and-mouth disease in U.K. cattle herds interrupted ongoing delivery of the product. In reality, the foot-and-mouth epidemic ... occurred over a year after the first purported sale, and none of the product had been delivered before the outbreak."

Hollinger International, Inc. (HLR)

AAER No. 2136, November 15, 2004; Litigation.
<http://www.sec.gov/litigation/complaints/comp18550.htm> January 16, 2004.

The complaint alleges three types of related party transactions by which the company's top management misappropriated the company's assets. First, the company's CEO and COO arranged for HLR to make payments of \$85 million to them (and to a company 78%-owned by the CEO) from the proceeds of various asset sales. The payments were purportedly for non-competition agreements. Second, the CEO and COO arranged for HLR to sell various assets at below-market prices to another company which they privately owned and controlled. Third, the CEO authorized HLR to invest \$2.5 million with a venture capital fund with which he and two other HLR directors were affiliated. The related party transactions were not disclosed, and the company's senior management is alleged to have misled the board and audit committee.

International Teldata Corporation

AAER No. AE-159. September 29, 1987. The complaint alleges that the company's CEO and chief legal officer caused shares to be issued to them for no consideration. "The stock was issued in a variety of ways, including through lawsuits, acquisitions of other companies, and in exchange for services and loans purportedly provided to the company." The share issuances occurred over several years, individually materially increased the number of shares outstanding, were not approved by the board of directors, and were not disclosed as a related party transaction. In some cases, the shares issued were placed in nominee names in accounts outside the U.S. in order to conceal them

Itex Corporation

AAER No. 1510. March 5, 2002; AAER No. 1229. February 15, 2000; AAER NO. 1224. February 10, 2000. The company managed an exchange for bartering goods and services and also was a principal in some barter transactions. The complaint alleges that between 40% and 60% of the company's revenue in each of four years came from "suspect and in many cases sham barter deals between Itex and various offshore entities related to and/or controlled by [the company's founder and control person]... The barter deals involved difficult-to-value assets, such as artwork, pre-paid advertising due bills, and worthless stocks in public companies. Some Itex deals involved purely bogus assets such as leases on vacant property, a non-existent stamp collection, and highly-questionable unpatented and undeveloped mineral claims."

Livent, Inc.

AAER No. 1095. January 13, 1999. The complaint alleges that the company's Chairman and CEO and its President engaged in a pervasive accounting fraud – from five years before and three years after its IPO. The frauds included: "a multi-million dollar kick-back scheme designed to misappropriate funds for their own use; the improper shifting of preproduction costs, such as advertising ... to fixed assets...; and the improper recording of revenue for transactions that contained side agreements purposefully concealed from Livent's independent auditors." The kick-back scheme involved Livent paying vendors for inflated amounts, and the vendors then kicking back money (\$7 million total) to the Livent's Chairman/CEO and its President either directly or via a company which the Chairman/CEO controlled. The company controlled by the Chairman/CEO was a related party (though not identified as such in the SEC filings) and presumably served to obscure the scheme. Another aspect of the fraud involved recording certain receipts as revenues when, in actuality, side agreements obligated the company to repay the funds. The SEC action identifies two of the counterparties in these transactions as related parties because Livent's top executives served on their boards. The Company did not disclose the transactions as related party transactions.

Madera International, Inc.

AAER No. 1452. September 19, 2001. The complaint primarily pertains to a series of acquisitions of timber property in South American countries, which were improperly valued (in total at about \$52 million), either by reliance on unsupported appraisals or by valuing the property based on the company's securities issued in exchange for the properties. One of purchases was negotiated with the president of a company who was, at the time, in prison for securities fraud. Failure to disclose related party transactions, consulting agreements with officers and directors, was only a small part of the action.

MCA Financial Corporation

AAER No. 1546. April 23, 2002. The complaint alleges that MCA's motive was to camouflage its financial problems in order to induce investors to buy its debentures and its lenders to continue to provide credit. "To avoid reporting significant losses in its financial statements, MCA executed a fraudulent scheme to inflate and mischaracterize its income, assets and equity in its financial statements from at least 1994 through 1999." The company's fraudulent scheme involved the following: (i) purchasing distressed rental properties, (ii) selling the properties to related partnerships at inflated prices and recognizing a gain, and (iii) financing the sales partly through receivables and partly through mortgages, all of which were carried on the balance sheet at inflated values. Specifically, despite the related partnerships inability to repay, MCA reported the receivables with no valuation allowance and the mortgages with inadequate loan loss provisions. Also, despite the related partnership's inability to repay MCA sold some of the related partnership mortgages to mortgage pools and some of which it held for resale. Further, MCA did not properly disclose the several million dollars of related party transactions.

NetEase.com, Inc.

AAER No. 2382-2384. February 27, 2006. The complaint alleges that the company recognized revenue for barter transactions that lacked economic substance. "The revenue helped NetEase "close-the-gap" between its actual results and analysts' expectations." In one barter arrangement, NetEase sold advertising services to Company A and bought offsetting services from Company B. Companies A and B were related parties. No services were actually performed. In another barter arrangement, NetEase sold advertising to -- while simultaneously purchasing an offsetting amount of financial advisory services from -- one of its key shareholders. No services were performed or received. In addition to \$2 million revenue for the barter arrangements, the company improperly shifted revenue to earlier quarters and also recorded fictitious revenue.

***Novaferon Labs, Inc.**

AAER No... 315. September 9, 1991. The complaint alleges that the company's CEO and directors controlled several companies that variously engaged with one another in lending, borrowing, asset sales, equity sales, and paying other's expenses. The effects were to understate Novaferon's liabilities and overstate its assets in filings related to its public equity offering. The SEC's action against the auditor noted that "Novaferon's finances were not separable from the finances of four other entities which were under common control with Novaferon." For example, the proceeds of the company's initial public offering were actually used to pay off a previously-undisclosed loan from one of the CEO's other companies.

***Pacific Waste Management, Inc.**

AAER No. 488. September 29, 1993. The complaint alleges that the company purchased, in an exchange of stock, an interest in another company owned by its president (who was also a director and the controlling shareholder.) The investment represented 98% of Pacific Waste's assets. The value of the investment was improperly based on the securities issued to obtain it rather than on the historical cost basis. The purpose was to inflate the assets of Pacific Waste so that the company's stock would not be a "designated security", i.e. one subject to securities laws designed to restrict certain sales tactics by broker/dealers involving speculative, low-priced securities (i.e. "penny stocks") traded over the counter.

***Pantheon Industries, Inc.**

AAER No. 644. February 15, 1995. The complaint alleges that the company reported as assets \$40 million of forged notes receivable from a foreign bank. In exchange for the forged notes, two of the company's executives had given the seller of the notes \$100,000 of their personal funds and payables issued by other companies they owned. The notes receivable represented 53% of the company's assets.

***PNF Industries, Inc.**

AAER No. 601. September 27, 1994. The complaint alleges that the company had improperly revalued patents in the process of effecting the combination of PNF's predecessor companies (Portafone and No Fire). The resulting overstatement of the company's assets and shareholders' equity enabled the company to qualify for a stock exchange listing. On the basis of percentage of shares acquired, it appeared that Portafone was the acquirer and thus the assets of the acquiree, No Fire, were revalued. Specifically, patents with an historical cost of \$463 thousand were improperly revalued to \$18.3 million. However, based on voting agreements between the controlling shareholders of the two pre-merged entities, the SEC action stated that properly "No Fire was the acquiring corporation, and the No Fire patents should have continued to be valued at their historical cost by accounting for the transaction as a reverse acquisition." Though not described as such in the SEC action, the business combination itself was a related party transaction since a single individual, Avasso, was both the controlling shareholder of Portafone and the owner of 49% of No Fire. After the business combination, a related party transaction enabled misappropriation of funds. PNF had authorized Avasso to convert warrants into common shares without paying the required \$630 thousand conversion fees. When the transaction was identified and questioned by the auditor, the explanation was that the conversion premiums were not required because they had

been offset against money owed by the company to Avasso. However, the company had not recorded any expenses, had not disclosed the related party transactions and did not correct their financial statements. Avasso had produced fictitious records documenting expense reimbursement claims and charges for consulting services.

The SEC described the records as improper on their face because they referred to periods prior to the time that Avasso became involved with the company; and further, there was no supporting documentation. In response to the auditors' request for evidence that the expenses had been authorized, Avasso had fabricated minutes for Boards of Directors' meetings, which the SEC noted were inconsistent since they included information that was not known until four months after the date on the minutes. The SEC's action stated: "Because this was a material related party transaction involving Avasso, a convicted felon, [...the auditor] should have closely scrutinized the evidence supporting Avasso's expenses. Nevertheless, [...the auditor] failed to review the evidence obtained and therefore failed to consider whether the minutes had been fabricated."

PrintontheNet.com

AAER No. 1755. April 8, 2003. In connection with a \$3 million private placement, the company's financial statements did not disclose that it had guaranteed \$7.3 million in related parties' loans, most of which was in default. Further, after the offering, the CEO transferred a portion of the proceeds to bank accounts controlled by his father.

Puryear Realty Resources, Inc.

AAER No. 651. March 6, 1995. Administrative proceeding. File no. 3-8766. Initial decision release No. 95 August 12, 1996. AAER No. 1586 September 27, 1996 The complaint alleges that the company used proceeds of an equity offering to make loans to companies in which Puryear's founder (also president and chairman) had financial interests. In its financial statements that were the subject of the AAER, Puryear Realty's assets consisted of improperly capitalized expenses, investments in one subsidiary that should have been consolidated and another that should have been accounted for under the equity method, and receivables, virtually all of which were due from affiliates. The largest amount in notes receivable was due from a company in which Puryear's founder had a 10% ownership and served as chief financial officer and which was controlled by his ex-wife. The largest amount in loans receivable was due from a company for which Puryear's founder was President. The founder of Puryear also sold the companies' securities without proper registration, and made the equity sale through another company of which he was the sole proprietor.

Refco, Inc.

Litigation Release No. 19716. June 5, 2006. This complaint, against a major Austrian Bank (BAWAG), alleges that the bank assisted Refco in concealing related party receivables using short-term borrowing and lending transactions straddling the company's fiscal year-ends from 2000 to 2005. Refco had hundreds of millions of dollars of related party receivables from a company owned and controlled by its Chairman and CEO. These receivables had resulted from the Chairman/CEO's company assuming obligations arising from customers' trading losses, a structure that eliminated the bad debts from Refco's balance sheet. The year-end transactions between Refco and BAWAG involved the following: Refco would deposit funds with (i.e. lend to) BAWAG; in turn, BAWAG would lend to the CEO-controlled company, which used the funds to pay off its obligations to Refco. As a result of these year-end transactions, Refco would reflect a deposit with BAWAG. BAWAG's financial reports would reflect a deposit from Refco and a loan to the CEO-controlled company.

Rite Aid Corporation

AAER No. 2328, September 30, 2005; AAER No. 2024. May 27, 2004; AAER No. 2023, May 26, 2004; AAER NO. 1579-1581, June 21, 2002; LITIGATION RELEASE NO. 17577 / June 21, 2002; related complaint: <http://www.sec.gov/litigation/complaints/complr17577.htm>. The complaint primarily

describes how Rite Aid inflated income by a total of \$2.3 billion in the following ways: by improperly inflating the amounts it claimed from its vendors for damaged and outdated goods, thus decreasing accounts payable and cost of goods sold; by omitting expenses for stock appreciation rights and for shrinkage; by retroactively and without justification increasing the depreciable lives of some assets; by improperly capitalizing legal and other expenses relating to potential new stores that were never built; and by prematurely recognizing a litigation settlement. Rite Aid also used reserves to smooth income, for example, accounting for gains on sales of stores as reserves against which subsequent expenses could be offset as needed. The company's top officers "profited from the fraud through cash bonuses tied to financial performance (in addition to the larger salaries)..." In addition to the massive overstatement of income, Rite Aid misrepresented several related party transactions involving the CEO's interest in real estate leased by the company. Also, Rite Aid did not disclose that it had funded the CEO's purchase – via a partnership controlled by the CEO and a relative – of a site that the company was considering for a store location and had then paid over \$1 million for improvements to the site.

***Softpoint, Inc.**

AAER NO. 666. April 27, 1995; AAER No. 706. September 1, 1995; AAER No. 709. September 14, 1995. The complaint alleges that the company reported fictitious sales to three foreign companies that were owned or controlled by the company's president and chairman. The financial statements did not disclose the related party nature of the transactions. The company used additional related party transactions, other than the sales to the president's companies, including: using the foreign, related companies to distribute unregistered securities; and issuing common stock to its executives that more than doubled the company's then-outstanding shares, which the SEC cited as "an out of the ordinary business compensation arrangement with related parties."

***Standard Oil and Exploration of Delaware, Inc. (STDO)**

AAER No. 641. January 19, 1995. AAER No. 867. January 6, 1997. The complaint alleges that the company obtained oil and gas properties from another company that was majority-owned and wholly-controlled by two of its own officers. Because the company "acquired the property in a transaction resulting in the original owners of the properties controlling the registrant", the SEC determined that STDO overstated its assets by over 300%, reporting the value of the acquired properties as \$2.4 million instead of their historical cost of \$578 thousand. In addition, the company also overstated its revenues by improperly accounting for funds raised from investors as oil and gas sales revenues; in one year, these improperly-recorded amounts represented 89% of total revenues. The company's president and chief financial officer also misappropriated funds.

Swisher International Inc.

AAER No. 1441-1442. September 10, 2001. The complaint alleges that the company sold a franchise to a company that was owned by its CEO, prematurely recognized the revenue of \$450 thousand for the quarter, and failed to disclose that it was a related party transaction. During another quarter, the company sold another franchise to a different senior officer and failed to disclose it was a related party transaction. Each of the undisclosed transactions allowed the company to report a profit rather than a loss for the applicable quarter. In addition, the company registered securities for sale and failed to disclose that its CEO was the beneficial owner of the securities (through a Bahamian company).

***Transmark USA, Inc.**

AAER No. 568. June 13, 1994; AAER No. 581. August 12, 1994; AAER No. 582. August 17, 1994; AAER No. 583. August 18, 1994; AAER No. 616. October 13, 1994. The complaint alleges that the company inflated the statutory capital and surplus of its primary subsidiary (GSL, a life insurance company) by 60% to 170% over five years using two techniques – one involving related party

transactions and the other involving round-trip security trades that straddled the fiscal year end.²² By inflating the statutory capital, the subsidiary circumvented restrictions on writing new insurance policies and on paying dividends to the parent company, thus misrepresenting the company's position in periodic filings and in filings related to offerings of the company's securities. The related party transactions involved two stages. First, Transmark restructured its ownership in other, non-insurance subsidiaries so that it controlled these subsidiaries through: (a) options and warrants rather than common stock (the common stock was held by shell corporations); and (b) agreements that allowed Transmark to direct the actions of the subsidiary. Having restructured its ownership, Transmark improperly claimed these non-insurance subsidiaries were not "related corporations" of GSL. In the second stage, transactions among the subsidiaries were used to falsely enhance the company's financial position. In one example, funds traveled in a circle: GSL extended loans to the non-insurance subsidiaries, who then paid dividends to Transmark, who then made a capital contribution into GSL. The result of the transactions was that GSL inflated its assets by including the receivables from the related companies in its asset base.²³

Tri-Comp Sensors, Inc. ("Sensors")

AAER Nos. 111 and 112. September 11, 1986. The CEO of Sensors was also controlling person for another private holding company. Most of the proceeds of Sensors' \$2 million initial public offering were used for loans to the private company, either directly to its subsidiaries or by providing collateral for the private company's borrowing. Some of the proceeds from the IPO were used to repay Sensors' indebtedness to the private company. None of the transactions were disclosed. In addition, the complaint describes the CEO's misappropriation and sale of \$1 million of shares in a public company of which he was the former Chairman.

Tyco International

AAER No. 1839, August 13, 2003. AAER NO. 1627. September 12, 2002 The complaint alleges that the company's three top executives -- the CEO and Chairman, the CFO, and the Chief Legal Officer -- improperly granted themselves loans from the company at zero or low interest rates, used the proceeds for personal expenses, and covertly arranged for some of the loans to be forgiven. The executives also received undisclosed compensation and perquisites. Undisclosed related-party real estate transactions included a purchase from the company by the CEO/Chairman's and a sale to company ("for far more than its fair market value") by the CFO. Undisclosed related-party transactions also included a finders fee paid to an outside director of the company.

ZZZZ Best Co., Inc. ("Z Best")

AAER No. 413. September 3, 1992. AAER No. 312. August 26, 1991. The complaint alleges that the company engaged in a sham asset purchase in order to inflate the value of its assets and thus qualify for listing on NASDAQ. Z Best reported the value of acquired assets as \$1.97 million; however, the assets

²² At year end, the company's insurance subsidiary sold high-yield securities and simultaneously purchased government securities, with a concurrent agreement to reverse the transaction a few days after year end. The SEC action notes: "In fact, no securities were actually delivered to either party and the only money that changed hands was the agreed-upon fee to [the brokerage company]." To the extent the subsidiary had only temporarily substituted less risky assets and had an agreement to reverse the transaction shortly afterward, it improperly reduced its statutory reserve requirements and thus inflated its statutory capital.

²³ Per the SEC's action: "For example, on December 20, 1989, GSL loaned \$ 12,400,000 each to two subsidiaries in Transmark's airline industry group in exchange for promissory notes from each entity which were included as admitted assets on GSL's balance sheet. On December 21, 1989, one of the two subsidiaries loaned \$ 12,400,000 to the other, and the second subsidiary paid a dividend of \$ 17,451,000 to Transmark. On December 22, 1989, Transmark made a capital contribution of \$ 17,451,000 to GSL. The result of these transactions was that GSL included \$ 24.8 million as admitted assets in its annual statement (the value of the two promissory notes). GSL should not have recorded the \$ 24.8 million as admitted assets because it represented investments by GSL in related corporations which were in excess of the amount permitted by Florida regulations."

had actually been purchased in a non-disclosed related party transaction. The company from which it purportedly purchased the assets had been specifically created to act as the purported seller and was controlled by a single individual who was a principal owner of Z Best. The actual cost of the assets was \$597,000. Also, the control individual personally received \$720,000 as compensation for his role in the fraudulent scheme.

Table 1

Uses of related party transactions to misstate the company's financial reports and/or misappropriate the company's assets, and instances from sample

Panel A. Sales of goods or services to (purchases from) related parties

Transaction	Misstatement	Misappropriation
Sale of goods or services to a related party	<ul style="list-style-type: none"> ▪ Fictitious transactions and mischaracterized transactions overstate revenue and typically accounts receivable. Related party feature not disclosed and... <ul style="list-style-type: none"> ⇒ Fictitious sales: Softpoint; Itext; NetEase.com; Horizon; Ciro ⇒ Inappropriate accounting: Livent, Humatech; C.E.C. ; Swisher; Ciro; FastComm 	<ul style="list-style-type: none"> ▪ Sale to related party at below-market price* can transfer wealth to related party <ul style="list-style-type: none"> ⇒ None
Purchase of goods or services from a related party	<ul style="list-style-type: none"> ▪ Non-reported transactions understate expenses. <ul style="list-style-type: none"> ⇒ None ▪ Related party feature not disclosed: <ul style="list-style-type: none"> ⇒ Madera; Tyco; Rite Aid; Pace American; First Humanics 	<ul style="list-style-type: none"> ▪ Purchase of non-existent or un-needed goods or services, or purchase at above-market price* can transfer wealth to related party <ul style="list-style-type: none"> ⇒ Improper or unauthorized payments for services: PNF; Chancellor; Livent; Hollinger; Enron (Chewco); ZZZZ Best; Biomaterials

Panel B. Sales of assets to (purchases from) related parties

Transaction	Misstatement	Misappropriation
Sale of assets to a related party	<ul style="list-style-type: none"> ▪ Over-valuing the sale of assets overstates reported gains (more relevant in non-monetary exchanges). <ul style="list-style-type: none"> ⇒ Inflated gains: MCA; Enron (LJM); Wilshire; Horizon ▪ Related party feature not disclosed: <ul style="list-style-type: none"> ⇒ Tyco 	<ul style="list-style-type: none"> ▪ Sale of assets at below-market price* can transfer wealth to the related party <ul style="list-style-type: none"> ⇒ Sale at less than market value: Hollinger
Purchase of assets from a related party	<ul style="list-style-type: none"> ▪ Over-valuing purchases overstates assets. <ul style="list-style-type: none"> ⇒ STDO; Great American; G. C. Tech; ZZZ Best ▪ Under-valuing purchases can overstate future reported gains. <ul style="list-style-type: none"> ⇒ None 	<ul style="list-style-type: none"> ▪ Purchase of non-existent assets or purchase at above-market price** can transfer wealth to related party <ul style="list-style-type: none"> ⇒ Purchase at greater than market value: Tyco

Panel C. Loans from (loans to) related parties

Transaction	Misstatement	Misappropriation
Borrowing from a related party	<ul style="list-style-type: none"> ▪ Misrepresenting understates liabilities. <ul style="list-style-type: none"> ⇒ Misrepresented borrowing from and lending to: Adelphia; Novaferon; Enron; Refco; ESM; Tri-Corp Services ⇒ Propping: Pantheon; First Humanics; Endotronics 	<ul style="list-style-type: none"> ▪ Borrowing at above-market rates* can transfer wealth to the related party <ul style="list-style-type: none"> ⇒ None
Lending to a related party (loans and receivables) or borrow for a related party via a guarantee or co-borrowing	<ul style="list-style-type: none"> ▪ Non-reporting of borrowing for a related party understates liabilities <ul style="list-style-type: none"> ⇒ Misrepresented borrowing from and lending to related party: Adelphia; Novaferon; Enron; Refco; ESM; Tri-Corp Services ▪ Related party feature not disclosed <ul style="list-style-type: none"> ⇒ To executives: Rite Aid; Adelphia; ESM ⇒ To related companies: Adelphia; Puryear; BBS; PrintontheNet.com ▪ Underestimating loan losses or doubtful accounts overstates assets <ul style="list-style-type: none"> ⇒ Mis-valued loans to related companies: Convenient Food; MCA; Oiltech ▪ Unspecified: General Technologies 	<ul style="list-style-type: none"> ▪ Mischaracterizing a disbursement as a loan can transfer wealth <ul style="list-style-type: none"> ⇒ Cronos ▪ Lending at below-market rates* can transfer wealth to the related party <ul style="list-style-type: none"> ⇒ To executives, below market: Rite Aid; Adelphia

Panel D. Equity investments in (equity investment from) related parties

Transaction	Misstatement	Misappropriation
Invest in equity of a related party	<p>Incorrectly identifying ownership structure can overstate assets or statutory capital, or circumvent individual-specific regulatory constraints.</p> <ul style="list-style-type: none"> ⇒ Inflated statutory capital: Dixie National; Transmark USA; ⇒ Inflated acquired assets: Pacific Waste Management; PNF Industries ⇒ Circumvented regulation: Altratech ▪ Related party feature not disclosed: <ul style="list-style-type: none"> ⇒ Hollinger 	<ul style="list-style-type: none"> ▪ Investing in an related party at above-market prices* transfers wealth to related party <ul style="list-style-type: none"> ⇒ Tonka
Sell equity ownership to a related party	<ul style="list-style-type: none"> ▪ Not identifying a related party as owner and subsequent seller of the company's equity can mislead investors about insider activity. <ul style="list-style-type: none"> ⇒ Swisher; Softpoint 	<ul style="list-style-type: none"> ▪ Selling equity ownership to an related party at below-market prices* transfers wealth to related party <ul style="list-style-type: none"> ⇒ International Teledata; Enron (Fastow and family investments in JEDI, Chewco, LJM)

* Include either: (a) transactions at off-market prices/rates or (b) transactions at market-price/market-rate but for off-market terms.

Table 2

Categorization of cases by the aspect of auditing related party transactions (RPTs) found deficient in SEC enforcement actions

Identification of related parties and related party transaction	Examination of related party transaction	Disclosure of related party transaction
International Teledata Pacific Waste Pantheon Softpoint STDO Tri-Comp Sensors	Atratech BBS Cascade Chancellor Convenient Food Mart Cronos ESM Flight Transportation First Humanics General Technologies Great American Itex MCA Novaferon PNF Puryear Realty	Adelphia G.C. Technologies Madera Transmark Tyco ZZZZ Best

The AAERs includes only minimal reference to related party transaction audit deficiencies for three cases (C.E.C.; Dixie; Oiltech). No AAERs for the auditor in the remaining 17 cases was found (as of June 2006).