

RELATIONS WITH RELATED PARTIES AND ENTITY'S MANAGEMENT

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ABSTRACT

Business globalization and broad access to the capital market's products confer a significant importance to the related parties, be it persons or entities which have the capital and/or exercise direction over, or are family members or close relatives.

Presenting the information regarding the relations and transactions with the related parties is the entity's management responsibility. Different studies notice that, in many cases, the management uses the decision-making powers to hide the relations with the related parties or uses the related parties to transfer upon them risks or debts. Some of the financial scandals with an international level impact brought into the spotlight fraudulent financial reportings by omitting to present or incorrectly presenting the relations and transactions with the related parties.

In Romania, Companies Acts and the capital market's legislation require the presentation of the relations and transactions with the related parties under conditions of complete information and transparency. It is noticeable that vicious organisation of the management systems leads to situations which allow the intentional veiling of these relations. Thus, miscorrelation of different documents in which responsibilities and hierarchical relations at a managerial level are stipulated create the possibility of sideslips from the presentation requirements .

Our study presents the situation of a quoted company whose general manager used the advantages of his position in order to hide the relations and transactions made with the related parties

KEYWORDS: *related parties, listed entities, executive management*

JEL CLASSIFICATION: *M14, M40, K22*

1. INTRODUCTION

Between commercial operations or operations of other nature which an entity usually makes, those which take place between the entity and the related parties are of high importance.

The entity's relations to the related parties, especially in those of public interest, but not limited to those, there are certain complementary initializing and presentation constraints, this meaning that, in this respect, the management's decisions have certain particularities.

A few of the international financial scandals with significant image impact showed off the frauds associated to the transactions with the related parties. Some of these have been the subject of the study and analysis in the specialized literature.

In 2007, a university study (Henry et al. ,2007) brought into discussion the related parties' transaction's role in the fraudulent financial reporting. There were presented references to famous fraud cases such as Enron, Adelphia or Tyco and the study included 48 cases of incorrect financial reporting and transactions with the related parties. There were pinpointed the most frequent situations in which the transactions were not presented: loans to the related parties; payments for unapproved or inexistent services to the employees' companies; sales of goods and services to related parties under the circumstances in which the transactions are not presented and the sales are fictitious or inadequately registered.

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Another study, published in Australia (Van Peurse et al., 2007) analyzed the financial breakdown of some corporations from the auditing's perspective. The study pinpointed the fraudulent practices related to the related parties, with whose aid the financial reporting was misappropriated. For instance, regarding the case of the famous scandal of the American company Adelphia, fraudulent actions consisted of: hiding debts in unfunded subsidiaries; misrepresenting the company's performances; omitting to present or vicious presentation of the relations to the related parties. Another example is that of the Australian company HIH Insurance, which, by the date of its emerging difficulties included over 250 subsidiaries all over the world, which offers us an image of the possibilities of using the related parties in fraudulent purposes. To this company's failure contributed fully the management, who did not respect the corporate governance/leading practices.

Presenting the related parties is considered important, thus there is an international financial reporting standard which sets the informations that must be presented during the financial reporting process. Moreover, professional trainings programmes dedicated to the skilled professionals in the area of applying or auditing the implementation of standards within the small and medium-sized businesses include modules regarding the presentation of the relations to the related parties and detailed explanations and case studies.

In Romania, the related parties' issue was not analyzed very much. We can bring into discussion a recent study (Tiron Tudor, Corlaci, 2013) regarding the harmonization degree of the Romanian law to the stipulations of the international standard regarding the financial reporting related to the related parties. The study pinpoints a few shortcomings of the harmonization process.

We think that a study which directly relates the presentation requirements of the related parties with the entity's management, in the particular case of the Romanian companies, completes the existent studies. Thus, we were interested in precise situations, attached to the management systems used in Romania, so that they pinpoint if, as far as the relations and transactions with the related parties are concerned, there are cases of default, of not informing or of fraud.

We studied the relevant laws regarding the related parties and the management's responsibilities regarding them, afterwards we began analyzing a particular situation which we encountered in a Romanian quoted company, thus undergoing some strict legal requirements regarding the inception, the development and the presentation of the relations and transactions with the related parties. Our purpose is to discover if we could identify actions of the management which do not respect the company's legal and statutory frame and the consequences of such sideslips.

2. WHO ARE THE RELATED PARTIES?

In the beginning we would like to ascertain the definitions of the related parties and the means by which they can be identified.

According to a professional dictionary (Menard, 2004), the related parties are defined as: „natural or legal persons which are related, meaning that one of them has the ability to fill directly or indirectly a surveillance or a considerable influence upon the decisions regarding the exploitation and financial management of the other, under the circumstances in which they are not independent from each other.”

The issue of the related parties requires an interdisciplinary approach since the management's decisions regarding the emergence and the existence of these persons, natural or legal, as well as those referring to the transactions between the entity and the related parties, are the subject of the presentation, relating to the transparency and the information presented to the investors and other interested persons during the financial reporting process.

The financial reporting has as body of knowledge the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB). Presenting the relations and transactions with the related parties is subject to the International Accounting Standard 24 (IAS

24 *Presenting the information regarding the relating parties*). According to this standard (CECCAR, 2012) the related parties can be classified as follows:

- An entity's affiliate is the one which surveills, is surveilled or lies under the shared surveillance under the form of the mother-company or of the affiliates, or the one which has an interest which grants it significant influence. The issue regarding this type of entities is provided by IAS 27 Consolidated and individual financial statements and by IFRS 3 Enterprise combinations;
- The affiliate is an associated company. This issue is provided by IAS 28 Investment in associated entities;
- The affiliate is joint venture. This issue is provided by IAS 31 Interests in joint ventures;
- The affiliate is a member of the key-stuff in the entity's management;
- The affiliate is a close member to the family of the person who surveilles or is member of the key-personnel;
- The affiliate is an entity in direct relation to the key-personnel or to a member close to his/her family.

It is understandable that the close family members are the domestic partner/spouse, the children and other persons dependant of these.

The transactions with the related parties are those which represent a transfer of goods, services or obligations between the related parties, whether there is a price or not.

The same standard very rigurously provides the information referring to the related parties which have to be presented within the explanatory notes of the financial statements.

As far as the public interest entities and the large enterprises are concerned, the financial reporting process requires the statutory auditors' intervention with the purpose of expressing an opinion regarding the accurate image of the financial statements. This intervention materializes into a statutory auditing report which accompanies the financial statements during the approval and publishing process. For this intervention the auditors use the International Auditing Standards (ISAs). Regarding the relations and transactions with the related parties, the auditors relate to the International Auditing Standard 550 (CAFR, 2013). This provides that the definition of the related parties assimilates their definition within the applicable financial reporting frame.

In Romania, the capital market law (Legea nr. 297/2004 regarding the capital market) imposes to the securities issuers complementary reporting requirements to the market surveillance organization (Financial Surveillance Authority- ASF).

This law introduces the term of involved person, which is defined simmilarly to its meaning in IAS 24 or ISA 550.

Referring the relations and transactions with the involved parts, there are stipulated exact provisions regarding the reporting, meaning that the managers of the companies operating on the capital market shall immediately report any transaction the company makes with the involved persons, when its added value represents at least the equivalent in RON of 50,000 EURO. The reports take the form of current reports transmitted to the oversight organization and shall include all the necessary information so that these transactions shall be presented completely and transparently.

3. THE MANAGEMENT AND THE RELATED PARTIES

In Romania, according to the corporate law, the responsability regarding the public's informing under transparency conditions regarding an entity's relations and transactions with the related parties is the manager's responsability. This obligation derives from the provisions regarding the strict compliance with the duties imposed by the law and, particularly, from the provisions related to the responsability regarding the assumption of financial statements and their advertising.

According to the Companies Acts (Legea nr. 31/1990), the Board of Directors may empower the company's management to one or several directors, naming one of those General Manager. Moreover, it is stipulated that, referring to the joint stock companies whose yearly financial

statements are subject to a legal financial auditing obligation, the management's empowerment is mandatory. Under these conditions, the responsibility regarding the publishing of the information referring to the entity, especially through the financial reporting process and the one required by the capital market laws, is their responsibility.

The same law stipulates which are the managers' obligations to which the empowered managers shall relate as well. Thus, the managers or directors must fill their mandate faithfully, must act to the entity's interest and must take responsibility for the decisions regarding the company's management.

If through their activity the managers generated damages, be it directly or by the fact that they did not adequately monitor the directors and the personnel, they are responsible for that. It is interesting to mention that the managers may be exonerated from the responsibility if, being aware of certain deeds or omissions, proclaim/declare themselves against them and inform the censors or internal auditors and the financial audit.

Referring directly to the relations with the related parties, the managers or directors who know that his/her family members are interested in an operation, they must inform the other managers (or the managers and the other directors, if it's a director's case) and they must not vote for this issue.

We may notice that the General Manager takes over, by empowerment, the direct and effective management responsibilities of the company, the representation and involvement of patrimonial liability in third parties relations (in this case the own signature becomes company authorized signer). At the same time, one takes the responsibility of periodically informing the managers and/or other empowered or chosen persons (auditors, censors) when the legal provisions or the internal laws require it. Generally speaking, the management contract stipulates as well the obligation of fulfilling the responsibilities faithfully and to the company's interest/benefit. The other directors, for instance the Economic Director, the Commercial Director, the Technical Director or other positions to which management and executive responsibilities are empowered basically have management responsibilities in their knowledge area and loyalty and bona fide requirements.

4. CASE STUDY

The case study was documented on the basis of an existent situation within a Romanian listed company.

The company is owned by a main shareholder who owns more than 50% of shares. The company's activity is managed by a Managing Board consisting of five members and the Auditing Committee is organised within. Being quoted, the company has the legal responsibility of having its financial statements audited and, as a consequence, the company's executive management is empowered to three directors: the General Manager/Director, the Economic Manager/Director and the Commercial Manager/Director. Each of them has an agreement between them and the company.

Basically, for each of the directors it is stipulated the obligation of managing the activity in the competency area, whilst for the General Manager it is stipulated the company's general activity and the duty of informing the Managing Board, the statutory auditor, the internal auditor and the censors, whenever the law or the contract/agreement requires it.

From the management agreements' provisions does not arise a hierarchization or subordination relation of the Commercial or the Economic Director to the General Director, the purpose being that of ensuring the decision-making process into a „direction committee”, but this aspect does not result explicitly.

In the organization chart the General Manager position is ranked higher than the other two, the Economic and Commercial Director, who are on the same level as the Technical Director, who is the company's employee, the latter without management contract. We may thus consider that the company's organization chart is not established according to the management agreements' provisions.

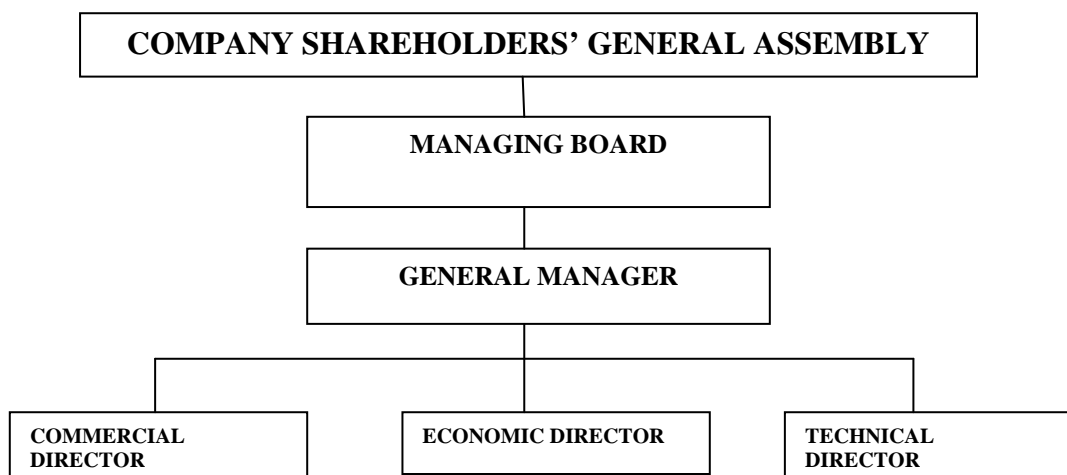


Figure 1: Organization chart

Not even the organizational and operational rules and regulations explicitly specify the way in which the directors operate within a „direction committee”, but don't mention either an exclusive subordination of the commercial and economic director to the general manager.

In this context, one noticed the following situation:

The General Manager determined and approved the conclusion of a service agreement with a company owned and managed by a 1st degree relative, failing to inform the other directors or the Managing Board regarding this aspect. This happened by disrespecting the operational procedures regarding the assessment and the selection of the service providers, which should have required the fulfillment of a Good Faith Report of the provider. Moreover, he asked and received the aid of some employees in the Sales Department, who did not inform hierarchically their direct manager, respectively the Commercial Director.

This situation determined that, at the end of the financial exercise in which the contract was signed (the commercial relations persisted for two years) and in the following situations, the financial statements and the yearly, semestrial and trimestrial reports did not include presentations regarding this relation with an related party represented by a 1st degree relative. We mention, as well, that these reportings were made under the direct responsibility of the General Director, who signed them on behalf of the society.

Moreover, after the transactions with this affiliated part exceeded the equivalent in lei of 50.000 Euros, the General Director (the only one who knew the existence of the related party) did not inform the Managing Board about this aspect, determining thus the non-compliance with the legal obligation of reporting this to the surveillance authority.

Through these actions the General Director infringed the following obligations provided by the management agreement:

- a) the obligations of periodically reporting, by not reporting/informing the Managind Board about the commercial agreement concluded with a company owned and managed by involved persons, even when the value of the transactions exceeded the equivalent in lei of 50.000Euros;
- b) the obligation of performing the activity faithfully and exclusively to the benefit of the company, by concluding an agreement with a company owned and managed by a 1st degree relative.

5. CONCLUSION

In Romania, far from the front-page financial scandals which brought in the spotlight, for several years, frauds associated with the affiliated parts of the several group companies, the situations basically bring into discussion the sideslips which may occur when the management systems are not strictly organized.

The circumstances which lead to these situations include:

- The mismatch of different documents which set obligations and responsibilities for the managing persons within a company. Even under the circumstances in which the company has implemented an integrated quality management system based on principles and procedures, this mismatch makes it, in many cases, inoperable;
- Expressing an autocratic managing attitude, based on the lack of precise provisions regarding the hierarchical structure and the relations between different leaders, especially when there is pursued a personal purpose. This attitude is determined, as well, by the lack of reaction of the other managing persons who accept a traditional hierarchization system, even though the system was not conceived that way;
- Inefficient organisation of the internal auditing system;
- The lack or the vicious organisation of the internal auditing function;
- The personnel's subservient attitude towards the directors, generally and toward the General Director in particular, which leads to the non-compliance and the failure to apply the procedures meant to ensure a corresponding operational system.

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