RELATED-PARTY TRANSACTIONS

Related parties: directors + controlling shareholders, and their relatives or companies

Value diversion = core issue in relationships between managers or controlling shareholders and the company

IAS (International Auditing Standards) 24 ensures that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

A related party is a person or an entity that is related to the reporting entity:

- A person or a close member of that person's family is related to a reporting entity if that person has control, joint control, or significant influence over the entity or is a member of its key management personnel.
- An entity is related to a reporting entity if, among other circumstances, it is a parent, subsidiary, fellow subsidiary, associate, or joint venture of the reporting entity, or it is controlled, jointly controlled, or significantly influenced or managed by a person who is a related party.

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged. If an entity has had related party transactions during the periods covered by the financial statements, IAS 24 requires it to disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements.

IAS 24 requires an entity to disclose key management personnel compensation in total and by category as defined in the Standard.

The cases of related-party transactions:

a) *Self dealing* = at arm's length negotiation

b) *managerial compensation*= agreements for directors and top officers

c) *taking of business opportunities*

d) trading in corporate shares, insider trading,

The related-party transactions are considered a type of "tunneling"(1)

Related-party transactions constitute the most common mechanism for tunneling because they allow insiders to extract private benefits not only through self-dealing but also by diverting corporate opportunities, mispricing transactions, or manipulating information flows.

(1) **Tunneling** is when controlling shareholders or insiders illegally or unethically shift a company's assets, profits, or resources to themselves or related entities, extracting wealth at the expense of minority shareholders or creditors, often through disguised related-party transactions like undervalued asset sales, excessive compensation, or unfair loans, while technically complying with legal procedures. It's a form of expropriation that benefits majority interests while harming others.

A- WHY PERMITTING Related-Party transactions

- small companies have no other choice but to operate with their managers, shareholders, etc.

Moreover, outsiders often face significant informational disadvantages relative to insiders. Because insiders have superior knowledge of the company’s operations, they may legitimately transact on better terms, reducing the risk of mispricing that would otherwise occur with unrelated parties.

- generally a related-party transaction can be entered into at better condition as the insider knows better the company!!

- absurd to prohibit manager compensation or trading in the company's shares

A blanket prohibition of RPTs would be both over- and under-inclusive: while it would block efficient transactions, it would not prevent more sophisticated tunneling techniques such as freeze-outs, asset stripping, or securities fraud, which require broader legal tools to detect and deter.

- prohibitions cannot stop “one-shot expropriations” (steal and run transactions) which are always illegal

- little abusive self dealing can be treated with civil liability and firing managers etc.

However related -party transactions are subject to legal constraints

B- LEGAL STRATEGIES for R.P. Transactions

1) affiliation terms = mandatory disclosure + dissolution rights

2) agent incentives = trusteeship

3) decision rights = shareholders approval

4) agent constraints = rules and standards

<u>AFFILIATION STRATEGY</u>

- Mandatory disclosure =

↓

ALERT shareholders + market

↓

THREAT of lower share prices

↓

RISK of REPUTATIONAL HARM

↓

FACILITATE ENFORCEMENT

Mandatory disclosure works by exposing suspect transactions to market and public scrutiny. By revealing insiders' material interests, it reduces information asymmetry and increases the likelihood of enforcement actions, even if no actual harm must be proven.

However, mandatory disclosure may trigger **over-enforcement**, as shareholders, regulators, or courts could challenge even legitimate transactions when they fear they may involve hidden opportunism. This risk is especially pronounced when disclosure rules are vague or overly broad.

- **Self-dealing transactions disclosure**
  - US (very demanding)
  - > $ 120,00 transactions where insiders have a material interest
  - = GAAP require annual disclosure of all material self-transactions
  - EU (less demanding)
  - IFRS annual disclosure
  - IV + VII DIRECTIVES

U.S. securities law adopts a highly demanding reporting regime, requiring annual disclosure of all material RPTs and specific reporting for transactions exceeding certain thresholds. By contrast, EU rules—especially prior to recent reforms—were significantly less stringent, allowing wider discretion to firms.

UK+France+Italy = high standards

Germany = lower standards but shareholders have right to ask

Japan = high standard

Within corporate groups, RPT risks are amplified because parent companies may influence subsidiaries to enter into transactions that benefit the group as a whole but harm minority shareholders at the subsidiary level. Disclosure regimes attempt to mitigate this by requiring detailed intra-group reporting

- **Mandatory disclosure of managerial compensation**

Disclosure of executive compensation has become a global trend, though jurisdictions vary between full individual disclosure and aggregate reporting. While intended to curb rent extraction and improve governance, these disclosures may lead to upward ratcheting of pay as executives benchmark themselves to “above-average” compensation levels.

all jurisdictions, with exception of Japan, ask for individual manager compensation

US: x CEO-CFO ad 3 most highly paid

EC mandates only aggregate compensation, but a EU recommendation requires disclosure of individual compensation for listed companies

single states = require individual compensation disclosure

Japan introduced executive pay disclosure when exceeding ¥ 100 million a year

Brazil requires only disclosure of aggregate compensations and for governance bodies

- Mandatory disclosure of trading in the company's shares

Disclosure of insiders' share trading allows markets to detect potential misuse of price-sensitive information. Many jurisdictions have gradually expanded the thresholds requiring disclosure, reflecting the increasing concern over subtle forms of insider manipulation.

US-JAPAN-ITALY = 10% of shares

EU and Brazil = director + senior executives for any trading

- shareholders = when overcome thresholds 5%→75% of voting rights

ROLE OF AUDITORS

[Listed Companies]

- International Standards on Auditing require auditors to pay special attention to related-party transactions

+ Statutory provisions (Italy - Germany - France - Japan - US)

[ex post enforcement]

failure to disclose

US= very effective (SEC actions, criminal prosecution, and private securities fraud class actions)

Ex post enforcement remains far stronger in the United States, where the failure to disclose RPTs can result in SEC sanctions, criminal prosecution, and private class actions. In most other jurisdictions, enforcement mechanisms are weaker, particularly for non-listed firms.

[Non Listed Companies]

US= no mandatory disclosure→ but voluntary compliance with US GAAP which allows disclosure

EU-JAPAN= no disclosure but court can appoint an expert to investigate suspect transactions

In many civil-law jurisdictions, courts may appoint special auditors or allow shareholder inspection rights to investigate suspected tunneling. These tools serve as substitutes for disclosure obligations in private companies, where formal reporting requirements are minimal.

Certain percentage of shareholders can inspect corporate books and records

Dissolution and exit rights

- to force dissolution (just for closely held companies, only when an abuse occurs systematically)

Exit rights function as a last-resort remedy to protect minority shareholders against systematic abuse. Although rarely applied, they play an important deterrent role by threatening controllers with forced buyouts or court-ordered dissolution when oppressive conduct is proven.

- put option = unhappy shareholders sell to controlling shareholders but determination of share price is an issue!

- however the courts tend to protect the company going-concern value by encouraging or requiring majority shareholders to buy-out minority shareholders