

Fraud in related party transactions: Can we spot the rot?



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At a public event held recently, a senior official of SEBI expressed concerns over related party transactions being the frequently used method by companies for diversion of funds. The observations came as no surprise as past trends of mechanisms used by companies worldwide to commit fraud have often involved using related party transactions as the conduit.

The trend of using related parties has prevailed over decades, with high profile cases like Enron, Adelphia, Tyco, Refco, Hollinger, Rite Aid, creating concern among regulators and other market participants about the appropriate monitoring and auditing of these transactions.

The story in India has been similar, where we have seen siphoning and mass scale

rigging of financial results using affiliated companies and controlled entities in many high-value frauds, whether in IL&FS, Bhushan Steel or diamantaire Nirav Modi group of companies, leaving hapless investors and citizens to pay for the bank losses wondering as to which gatekeeper failed in its oversight.

In recent years, the increase in the number, complexity and pervasiveness of reported frauds, including those reported by banking companies, have led to the financial community posing the question: *Are there some transactions which are more likely to be vehicles of fraud? Can those be detected early?*

Global research by academia and regulators veer towards the conclusion fact that transactions routed through parties that are related, controlled or influenced by owners and management, irrespective of there being any common ownership or not, are the key conduits for perpetrating financial frauds. This relationship leads to collusion, opacity and complexity which is difficult to disentangle and segregate as fraudulent transactions, till it is too late. In most cases, the frauds are detected by chance or by admission of the perpetrators when there are no means left to continue the cover up.

Under the Companies Act, 2013, a related party, with reference to a company, includes a director or his relative, a key managerial personnel or his relative, a firm, in which a director, manager or his relative is a partner, a private company in which a director or manager is a member or director, a public company in which a director or manager is a director or holds along with his relatives, more than two per cent. of its paid-up share capital, anybody corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager, any person on whose advice, directions or instructions a director or manager is accustomed to act. This pervasive and detailed definition brings into the purview any legal person whose dealings with the company in question are subject to further scrutiny.

Research into the fraud mechanisms show an increasing use of related party transactions by companies, the common types being purchase or sale of goods or services from related parties, in which payment was made, but the purchase was either undisclosed, unapproved, or non-existent. The next two most frequently occurring type of RPT was lending or investments, i.e., extending loans or investments that were improperly disclosed and/or improperly valued to related companies and to executives.

In India, the trend seems to be moving in a similar direction. A study recently found that more than half the companies perpetrated frauds, either through sales and purchases to related parties and/or shell companies that were related parties, or through loans granted to related parties (interest free or otherwise), or through investments in subsidiaries. It is seen that the frauds are mainly facilitated through fictitious sales to and purchases from related parties, long outstanding dues from and to related party debtors and creditors, related party advances and debtors were written off, related party transactions were not disclosed as per the requirements of the law and accounting standards even though these related party relationships existed, transactions with related parties were undertaken without the requisite approval of shareholders and other stakeholders, several related party transactions, when investigated, were not supported with adequate evidence and documentation to prove the genuineness and business purpose of these transactions, and loans availed were diverted for personal use of promoters and/or directors.

The referred study further found that fake transactions and records account for more than 28 per cent of reported

instances of sample frauds (by value), and manipulation of the financial statement was the vehicle through which this was mainly perpetrated.

Given the volume of frauds that use related parties as conduits, it has been found that fraud firms have significantly more related party transactions than non-fraud firms. Additionally, the higher frequency of related party transactions for fraud firms suggests that the presence of related party transactions may reflect heightened fraud risk. However, it is essential to note that this is mainly applicable to non-disclosed related party transactions, since related party transactions are a lawful practice and legitimate activities that serve practical purposes recognised in corporate and taxation laws with their own standards for accounting treatment, with specific systems of checks and balances built around them to make sure they are conducted within these boundaries of the law.

These frauds are mainly conducted through investments in, sales to, purchases and borrowings from related parties.

Investments in related parties

It is essential and mandatory under law to disclose investments in related parties, these, if not reported correctly, could lead to an overstatement of assets and mislead investors. High non-current investments imply that the company is diverting funds through investments in related companies at a high premium or through loans and advances. The diverted amount is included in the provisions made by the company in the financial statements for diminishing the value of investments, leading to an increase in expenses due to these exceptional items. This has been evidenced in various recent SEBI enforcement orders issued against companies, for instance, in case of Assam Company India Ltd (ACIL)¹, an investment of Rs.24.95 crore in Mexia Resources Limited was shown in the books of Duncan Macneill Power India Ltd. (a subsidiary of ACIL). Here, ACIL failed to submit certificates and evidence showing investment in compulsory convertible preference shares amounting to Rs.24.95 crore of Mexia Resources Ltd. Thus, there arose a strong suspicion as to the genuineness of the investment made by ACIL in Mexia and consequent misrepresentation of financials by ACIL.

In another reported instance, Inter Globe Finance Limited (IGFL)², the annual report for FY 2015-16 disclosed its investment in 6 subsidiary companies for Rs.34.64 lakhs as a non-current investment. However, as per the Share Certificate submitted by Inter Globe, and the shareholding pattern of the invested companies filed with the Ministry of Corporate Affairs, it appeared that IGFL was not the shareholder of these companies as on March 31, 2016 and the transfer of the shares was registered only on September 01, 2016, raising a prima-facie suspicion of misrepresentation of financials.

Sales to related parties

Sales to related parties may lead to corporate frauds if the transactions can be categorised as fictitious sales. Fictitious sales have been defined as simultaneous pre-arranged sales transactions, often of the same product, in order to create a false impression of justifying those fictitious sales transactions of falling under the normal ordinary course of the business. This can lead to an overstatement of revenue. Through the conduit of an increase in sales and accounts receivables, the company appears to have a better financial standing with greater credit worthiness to avail bank loans, and later siphon off the fund so received from the bank.

This concern was highlighted in SEBI's orders in the matter of K Lifestyle India Ltd, Arvind Remedies Limited and Tree House Education and Accessories Limited cases.

K Lifestyle India Ltd submitted that all the direct and indirect expenses of the company are borne directly by their customer Asahi Industries Limited. However, in its representation, it has submitted a list of its major clients who contribute to its revenue amounting as of March 31, 2017, wherein AIL did not appear as a major client in its financial statement.

In the matter of Arvind Remedies Ltd³, the company purchased majority shares in certain controlled entities, which it later sold back to them. This was done to avoid or to minimize the extra outflow of VAT and to maintain revenue neutrality. Sales to these parties were not shown in Arvind Remedies' actual books of accounts. Further, Arvind Remedies was regularly inflating sales and purchases, and not manufacturing goods as entered in its Annual Accounts, which was relied upon by financial institutions while allocating loans and lines of credit. Arvind Remedies primarily represented these transactions by way of records of non-existent movement of goods, for example fake bills generated on customers who did not requisition such purchases. In many cases, ARL only passed book entries under its Parties' Control Account or Journal Control Account, or the purchase account was debited for an amount and the supplier account was credited simultaneously. Later, the goods were shown to have been sold and the customer's account was accordingly debited. ARL used the Controlled Entities for showing debits and credits. The credit received from the Controlled Entities were used to net-off the receivables of several debtors including State Owned Enterprises, as those sales were fictitious. Finally, Tree House had debts amounting to Rs.82.64 crores recoverable from its debtors. Out of this amount, Tree House had written off Rs.25.53 crores as bad debt by making a provision for doubtful debts in its Annual Report. This write off raised some red flags, because such a provision and this sort of accounting treatment was unusual for the education sector. Further, SEBI found that its promoters prima facie appeared to have benefitted from this write off, amongst other related party transactions.

Purchases from related parties

Purchases from related parties is another way of transferring wealth to related parties is through unnecessary purchases of goods and services or purchases above market price, which is another method of siphoning off funds borrowed from banks and lenders. This was evidenced in Venmax Drugs and Pharmaceuticals Ltd⁴, where the company had entered false purchases and sales in its financial statements. As per its Annual Report for the financial year 2016-17, the total purchases and sales reported were Rs. 24,42,000 and Rs.25,92,000, respectively. The company stated that it has only one bank account in State Bank of India, through which all business-related activities are carried out. Total credits and total debits in the bank statement for FY 2016-17 are Rs. 3,63,000 and Rs.6,73,193 respectively. The full value of sales and purchases was not reflected in the bank statement of Venmax thereby leading to the suspicion that the transactions carried out by Venmax were either non-existent or in cash. In the same year, its books show purchases from only one seller, who appears to be a connected party of Venmax, as it is registered at the same address as Venmax.

Borrowings from related parties

Borrowings from related parties could lead to a non-transparent system and an inaccurate estimation of the company's financial position. If loans given to related parties by an entity are reported accordingly in the financial records, the issue arises of collateral pledged arises. Typically, in case of related party transactions companies tend to overstate the value of these collaterals.

This was seen in Assam Company Limited, Tree House Education and Accessories Limited⁵ and Hit Kit Global Solutions⁶. In the case of Assam Company Limited, the company had 8 subsidiaries and 3 Step-down Subsidiaries. As per ACIL's annual report for FY 2016-17 a total of Rs.279.06 cr. and for FY 2015-16 a total of Rs.259.66 cr. was due from its subsidiaries. Out of the total loan amount due from its subsidiaries, 90 per cent was due from Gujarat Hydrocarbons and Power SEZ Ltd. (GHPSL), which could've been the subject of significant governance issues. While providing documents to substantiate the legality of the above transactions, ACIL provided vague particulars of the entries appearing in the books of GHPSL and failed to provide documentary evidence and supporting documents, like actual contracts and proofs of disbursement to entities. This gives rise to a strong suspicion that the amounts shown as "long term loans and advances" in its books have been misused. Specifically, with respect to the amount shown as loan due from Ruhi India Ltd, in my view, there is prima facie evidence of misuse of funds / accounts and a suspicion of misrepresentation of financials by ACIL. The funds received as term loans from banks being diverted to related parties either through loans and advances or settlement of purchase related liabilities. Since, as per Ministry of Corporate Affairs records, the name of Ruhi India Ltd, has been struck off, which shows that loan has been shown against an entity which does not exist.

In the instance of Tree House (as referred), long Term Loans and Advances were made by the company to the Educational Trusts (where one of its Promoters was a Trustee), for setting up K-12 Schools which was not disclosed in its annual reports.

In Hit Kit Global solutions, false transactions were accompanied with an explanation sought from the company with respect to ₹100.00 lakhs advance for the procurement of second hand and used water 'Lift Irrigation' equipment, the company did not provide details regarding date of payment and party to whom advance has been given. Also, no documentary evidence of payment of advance had been submitted. Further, the advance of Rs.100 lakhs also appeared under the head "Long Term Loans and Advances – Other advances" in its books for the financial year 2014-15, and in the Balance sheet for the financial years 2014-15 and 2013-14, the head "Long term Loans and advances" shows almost the same amount. Hence, from the above balance sheets, it, prima facie appears that the amount has been carried forward from the financial year 2013-14. The amount of advance appears to have been paid more than 3 financial years ago for the said purchase of irrigation equipment by the company. The authenticity of this advance also could not be verified as no supporting documents to this effect were provided by the company. In this regard, since the amount of Rs.100 lakhs have not been fructified for more than 3 financial years, prima facie there is a suspicion regarding the authenticity of the said transaction.

In conclusion, since related party transactions in and of themselves are not an illegal activity or evidentiary of fraudulent transactions, it becomes important to tread lightly and carefully whilst entering into this realm of business. By adhering to the statutory standards laid down in the applicable laws and conducting a careful and periodic audit of the books of the company, these transactions would not raise any red flags or cause for suspicion amongst the regulatory authorities.

¹ Interim Order, SEBI. WTM/MPB/ISD/105/2017

² Interim Order, SEBI. WTM/MPB/ISD/144/2018

³ SEBI Order, WTM/SR/CFD-FAC/08/02/2017

⁴ SEBI Interim Order, WTM/MPB/ISD/ 110 /2017

⁵ SEBI Interim Order, WTM/GM/CFD/96/2017-18

⁶ SEBI Interim Order, WTM/MPB/ISD/ 17 /2017