All in the family and relations

Related parties, friends and family: the mechanics of related party transactions and fraud in India

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Vulnerability of Related Party Transactions: A Background

The conversation on related party transactions (RPT) in business has been a contentious one for long. This is despite evidence amply establishing that RPTs are largely legitimate and entered into in the ordinary course of business for various economic and logistical reasons such as an understanding of the capabilities of parties to the transactions concerned, ease of negotiating better prices (although at arm's length, as required across geographies). However, these transactions are also susceptible to misuse due to the close relationships involved and the authority one party exercises over the other, leading to enrichment of majority shareholders at the cost of the minority shareholders, the company and other stakeholders. Therefore, while all RPTs cannot be assumed to be suspect and/or fraudulent, a large number of frauds that are detected involve diversion of funds to and through related parties.

In a 2018 study by Thought Arbitrage Research Institute (TARI) for the Ministry of Corporate Affairs, the sample of financial statement frauds occurring between 2012-2018 found that related party transactions were conduits for the fraud in a majority - either through sales and purchases to related parties and/or shell companies that were related parties, or through loans granted to related parties , or through borrowings from related parties, etc.

Puchniak and Varottil[1] did an in-depth analysis of the actual function and regulation of RPTs in Commonwealth Asia's most important economies against the backdrop of the World Bank's Doing Business Report (DBR) of which the RPT index is prominent. The DBR ranks 190 jurisdictions across the world on various parameters including the quality of their laws regulating RPTs. Commonwealth Asia appears to be a corporate governance utopia with regulation of RPTs among its most important economies being stellar. In the 2018 RPT Index referred to in this analysis, Singapore ranked 1st, Hong Kong 3rd, Malaysia 5th, **and India 20th**. However, despite the uniformly high RPT Index scores in these economies and ***the RPT Index ranking India and Malaysia as world-leading for RPT regulation, overwhelming evidence suggests that both jurisdictions have systematic problems with abuse of RPTs by controlling shareholders for the purpose of tunneling***.[2] They concluded that there is a conspicuous gap between what the RPT Index suggests should be occurring and what is actually occurring in practice.

At an OECD seminar organized by SEBI in 2019, then SEBI Chairman said that the Board was looking at improving existing norms on related party transactions considering that the increasing prevalence and use of group companies had brought several governance issues to the fore, especially on related party transactions. He further explained that the use of complicated group structures and complex related party transactions had raised concerns on siphoning of funds, money laundering, round tripping etc.[3]

In this context therefore, an RPT focused fraud prediction model becomes essential. The rising cases of corporate wilful defaults on bank loans and money laundering leading to diversion of funds to related parties and the growing size of such frauds makes this an imperative.

Characteristics of Firms Committing Fraud

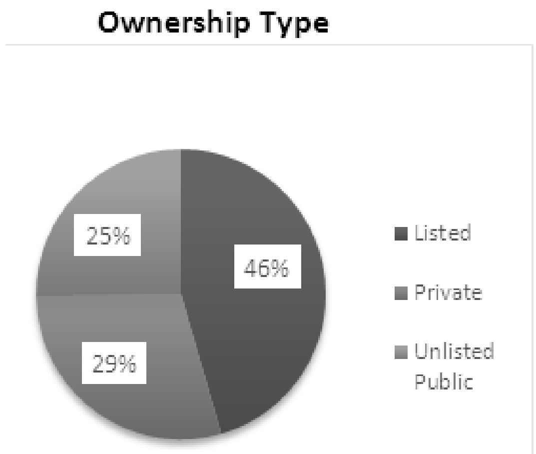
The 2018 TARI study and an updated analysis of a sample of companies that have been indicted for fraud between 2012 and 2020, and where related parties have been found to be the channels for fund diversion suggests a growing problem, despite a strong legal framework.

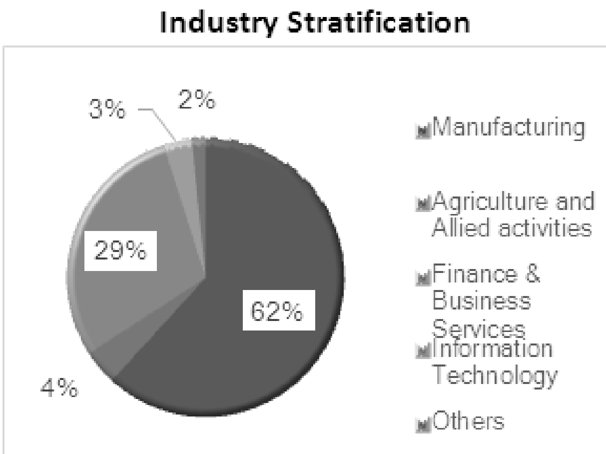
Ownership & Industry Stratification

71% of the companies analysed were public companies and 29% private companies, a previously observed trend as well, in which a majority of the sample were public companies (59%) while 41% were private.

In an earlier TARI study covering frauds investigated during 1997 to 2012, public companies accounted for about 56% of the cases, while 44% were private companies.

This rise appears consistent with reports of big companies being indicted for fraud in recent years and suggests that they are increasingly occurring in companies with a larger public stake putting public wealth in jeopardy.





A significant majority - 62% of the sample, was from the manufacturing sector, a rise from 45% previously (and 35% in the 1997-2012 study period).

Almost two-thirds of these manufacturing companies are from only 3 sub-sectors - food products and beverages, metals and chemicals, and construction and infrastructure (including energy). Previously, while metals and chemicals, and food products and beverages found top billing in the manufacturing sub-sectors, textiles and wearing apparels, and machinery and equipment were also among the top.

No particular trend thus appears in the manufacturing sub-sectors.

Value Lost in Frauds

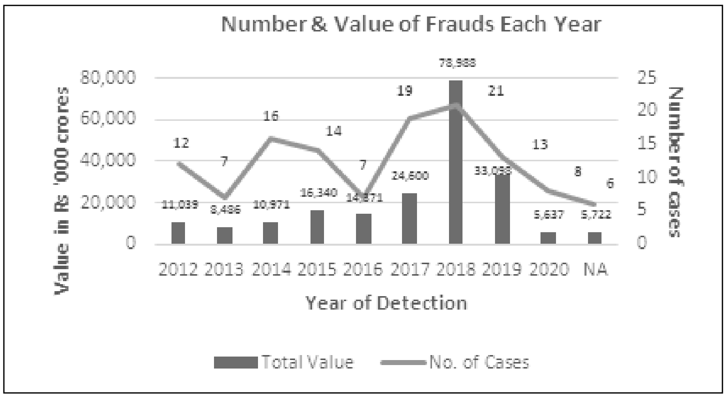
The total value of frauds in the current analysis is Rs 2.09 lakh crores vis-à-vis Rs 1.18 lakh crores in the previous study. The average fraud size is more than twice as high, at Rs 1,701 crores versus Rs 726 crores in the earlier study.

Year	Current Analysis (2021)			2018 Study		
	Value*	No. of Cases	Average Value*	Value*	No. of Cases	Average Value*
	2,09,252	123	1,701	1,18,347	163	726

*Rs crores

In the current analysis a few big-ticket cases reported in 2018 (like Gitanjali Gems, Ruchi Soya, ILFS and Adarsh Buildestate) and 2019 (DHFL) account for the upsurge, with fraud amounts upwards of Rs 9,000 crores each.

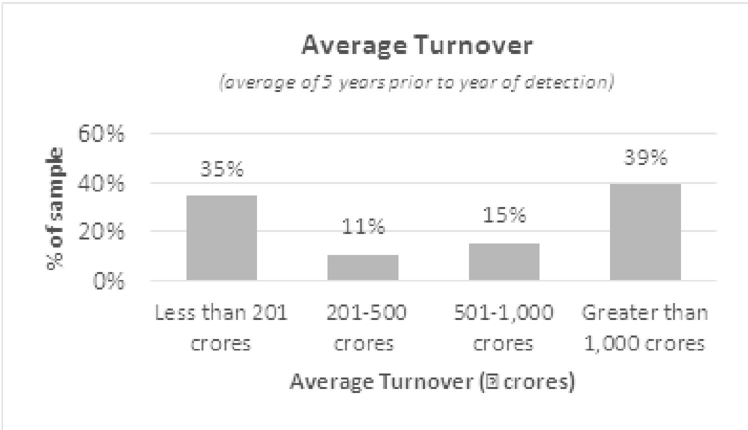
This significant increase may be attributed to strengthened enforcement and a crackdown on shell companies. As of September 2020, in the preceding three years, more than 3.82 lakh shell companies had been struck off the Registrar of Companies following the "Special Drive for identification and strike off Shell Companies."



2018 saw the highest average value of frauds detected in both studies. In our current analysis it is Rs 3,761 crores versus Rs 2,384 crores in the same year in the previous study. Thus, while more frauds are coming to the fore due to stricter vigilance, the value lost is also increasing significantly.

High instances of fraud detection normally follows significant events or reforms:
- 2017 saw demonetization,
- In 2016 the Insolvency and Bankruptcy Code was enacted,
- Strengthened monitoring mechanisms by the RBI including instructions to banks to:
  - o implement security and operational controls
  - o closely monitor end use of funds, obtain certificates from borrowers that funds are being utilised for the stated purposes with penal consequences for wrong certifications,
  - o focus on early fraud detection and prompt reporting to RBI and investigative agencies.

Prior to 2017 the average value of frauds was Rs 1,144 crores, post 2017 it has increased by 145% to Rs 2,803 crores.



Turnover of Fraud Firms

39% of the sample had an average turnover of more than Rs 1,000 crores, 35% were also less than Rs 200 crores - the risk of fraud is thus pervasive irrespective of company size.

These characteristics reveal that while frauds have been rising over the years with individual losses increasing exponentially, they are agnostic of company size, but are more rampant in the public sector and manufacturing industry.

Characteristics of the Frauds

Literature on fraud and fraud prediction has extensively documented some of the common routes and patterns by which frauds have been perpetrated. Transactions with related parties or shell companies that were related parties are the most common channel for committing fraud. This is not to say that related party transactions themselves are all fraudulent, but that such transactions are more susceptible to fraud than others. Loans and advances to related parties are among the most frequently used routes for diverting funds as low or no interest-bearing loans.

Silanes et al (2003) found that loans to related parties enjoyed on average about a four percent lower interest rate and the borrowers had lower credit worthiness. Kahle and Shastri (2004) found that loans to executives have an interest rate below the market rate.

Gallery et al. (2008) in a study of listed companies showed that controlling shareholders tunnel out resources from companies through related party payments and loans.

Ge et al. (2010) also found in their study that firms tunnel out assets through sale of goods and assets to related parties.

Cheung and others (2009) identified **connected transactions** that are likely to result in expropriation of the listed firm's minority shareholders – acquisition or sale of tangible and intangible assets between connected persons accounted for 66% of the transactions analysed; trading relationships (involving trade of goods and services) and cash payments (including loans and cash assistance) accounted for 25%.

In a study titled "Role of Related Party Transactions in Fraudulent Financial Reporting" (Henry and others - 2007) the most frequent type of transactions in the sample analysed 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.

This study concluded: Overall, research is inconsistent with 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. Misstatements and misappropriation can be achieved with or without related party transactions.

Unlike the public and professional perception mentioned by Henry et al, our analysis is not grounded on the assumption that related party transactions are by themselves fraudulent, it is based on earlier studies and TARI's own previous work on the subject, from which we can conclude, that where a fraud has taken place, the use of related parties and RPTs to perpetrate that fraud is a highly likely finding. We also often observe a combination of misstatement and misappropriation in the same company. We find the final objective is misappropriation of company or loan funds received from banks, which have been fraudulently obtained based on financial statement misstatements. These funds/loans are then siphoned off to RPs through loans, purchases or investments.

In their study on strategic default (on bank debts) by firms, Shanker et al. (2019) observed that strategic defaulters tunnel cash by making large loans to related parties which are significant ex ante predictors of strategic default as against distress default.

The 2020 Economic Survey of India extensively discussed the role of related parties in facilitating wilful defaults on bank loans thus further establishing the role of RPTs in frauds. The survey noted that wilful defaulters make large loans to related parties. ***While the average distress defaulter or non-defaulter in the sample is a net recipient of loans from related parties, wilful defaulters are net givers of loans. Peculiarly, they are net recipients of external loans and defaulters on these loans at the same time that they are net givers of loans to their related parties.***

In each of these scenarios, loans have been raised with the unmistakable intent of siphoning them off for the benefit of the owners.

Our analysis also finds that loans and advances to related parties are the most common channel for siphoning funds.

Type and Frequency of Related Party Transactions in the Analysis			
FS Area	Description	%age to Total Sample	
		Current Analysis	Previous Study
Loans and advances to related parties	• Diversion of funds to related parties as loans and advances at either low or no interest; • No underlying business purpose for the loan/advance; • No written agreements.	82%	25%
Sales to RP and RP debtors	• Inflated or fictitious sales and resultant debtors primarily for obtaining bank loans; • Round-tripping through export sales; • Sales at below market price;	37%	30%
Purchases from RP and RP creditors *(including capital asset purchases/sales)*	• Fake purchases for diverting company funds to RP creditors for personal use; • Purchase of capital assets at higher than market; • Purchase of poor quality assets, redundant assets/services that have no genuine business imperative.	28%	13%
Investments in RP	• Diversion of loan funds to RP and/shell companies with no business activity and no underlying • Investing at above market value	9%	10%
Borrowings from related parties	• Borrowing at above market price	2%	10%

In at least 22% of the cases in our current analysis, diversion took place through shell companies.

Predicting Related Party Fraud: A Current Imperative

The risk of fraud is pervasive irrespective of company size. Evidence also indicates that public companies especially in the manufacturing sector are most susceptible to fraud.

It has also been established that related parties are central to a majority of frauds and funds are diverted through myriad transactions with such connected entities. As Kohlbeck et al. (2003-04) state "When we examine the relationship between RPTs and the extant literature's corporate governance mechanisms (such as board characteristics, CEO pay-performance sensitivity, and outside monitors), we generally find weaker corporate governance mechanisms associated with more and higher dollar amounts of RPTs." This implies, the weaker the corporate governance the larger the related party transactions are likely to be, the greater the risk of fraud.

It is these weaknesses and vulnerabilities that have prompted a focus on RPTs, and stricter laws and regulations to monitor them. The laws in India (enumerated in the Companies Act, Accounting Standards, SEBI regulations, Income Tax Act) call for fraud risk assessment with an emphasis on related party transactions, greater transparency and better disclosures to ensure that they are at arm's length, thereby protecting the interests of minority shareholders and other stakeholders.

In the World Bank's 2020 DBR, India continues to rank high in the "protecting minority investors" sub-index which measures minority shareholders' rights in related party transactions and in corporate governance, although it fell from 7 in 2019 to 13. However, as Puchniak's and Varottil's analysis and the analysis presented here show, the mere existence of robust laws is not an indicator of the reality when it comes to misuse of related parties and transactions with them.

Strong laws and regulations do not necessarily act as deterrents if implementation remains weak. Stricter implementation, monitoring and due diligence are essential ingredients for detecting and preventing fraud.

While we strive to improve our rankings further, we must not lose sight of the fact that despite a robust legal framework the value of frauds detected over the years has been increasing. This is a cause for concern since larger losses have multiple and ripple impacts including:

- erosion in value of the company and possible going concern issues,
- losses for minority shareholders,
- lower investor confidence
- loss of faith in the financial sector,
- falling credit,
- financial instability and
- dipping infrastructure development and overall economic growth.

There is no doubt that stringent laws have contributed to the increasing detection of and indictments for fraud in recent years. But fraudsters are always on the lookout for ways to circumvent the law and will eventually find loopholes if monitoring and implementation are not equally stringent, especially of related party transactions.

A financial statement data driven fraud prediction model with special emphasis on related party transactions could therefore go a long way in early detection of fraud and preventing them from escalating beyond control. Otherwise, we may end up only "detecting" more large industrialists only after they have siphoned off sufficient funds from their companies and lenders to finance their luxurious lifestyles as fugitive offenders who have managed to escape the long arm of the law in India.

[1] Puchniak, Dan & Varottil, Umakanth. (2018). Related Party Transactions in Commonwealth Asia: Complexity Revealed. SSRN Electronic Journal. 10.2139/ssrn.3169760.

[2] Puchniak, Dan & Varottil, Umakanth. (2018). Related Party Transactions in Commonwealth Asia: Complexity Revealed. SSRN Electronic Journal. 10.2139/ssrn.3169760.

[3] https://economictimes.indiatimes.com/markets/stocks/news/sebi-working-on-related-party-transaction-norms-tyagi/articleshow/72259749.cms?from=mdr