

Original Research Article

Research on definition, fraud methods, and audit countermeasures of implicit related-party transactions

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Abstract: With the increasing complexity and concealment of related-party transactions of listed companies, implicit related-party transactions have gradually become a new means of financial fraud, posing a severe challenge to auditing work. Research has found that implicit related-party transactions are mainly implemented through four major means: de-association of related-party relationships, third-party bridge transactions, and post-transaction de-association. However, the current regulatory penalties for implicit related-party transactions are insufficient and the penalty measures are single, which further encourages the violation of regulations by enterprises. Auditors can enhance their ability to identify and respond to implicit related-party transactions by strengthening professional skepticism, deepening the identification of related parties, applying data analysis, and optimizing audit procedures.

Keywords: hidden related-party transactions; de-association; information disclosure; identification of related parties; industrial and commercial big data

1. Introduction

With the rapid development of global economic integration and the market economy, the frequency of related-party transactions among listed companies has been increasing. In China's listed companies, related-party transactions occur very frequently. As a common economic behavior, related-party transactions are an important means for enterprises to allocate resources and manage risks, which can help reduce transaction costs and improve capital efficiency. However, related-party transactions are also a "hotspot" for financial fraud. Improper related-party transactions often come with risks such as interest transfer, profit manipulation, and even financial fraud. Common types of related-party transactions include related-party purchases and sales, related-party guarantees, related-party fund occupation, and related-party transactions. Among them, related-party purchases and sales are the most common and typical (Huang Shizhong et al., 2024)^[1], and are often used by listed companies to fabricate transactions and manipulate profits. However, with the continuous improvement of accounting information disclosure systems and the strengthening of market supervision, it is easy for experienced auditors to identify financial fraud through ordinary related-party transactions. Therefore, implicit related-party transactions, with their complexity, particularity, and concealment, have become a new common means for listed companies to conduct financial fraud through related-party transactions, posing unprecedented challenges to auditing work.

2. Definition of associated relationships and implicit associated relationships

2.1. Definition of associated relationship

Regarding related party relationships, the "Basic Standards of Accounting Standards for Business Enterprises" clearly states that when one party controls, jointly controls another party or exerts significant influence over another party, or when two or more parties are controlled, jointly controlled or significantly

influenced by the same party, they constitute related parties. Article 260 of the new "Company Law" stipulates that a related party relationship refers to the relationship between a company's controlling shareholder, actual controller, director, supervisor, senior management and the enterprises they directly or indirectly control, as well as other relationships that may lead to the transfer of the company's interests. However, state-controlled enterprises do not have a related party relationship merely because they are both controlled by the state. Regarding related party transactions, the "Accounting Standards" stipulates that related party transactions refer to the transfer of resources, services or obligations between related parties, regardless of whether consideration is charged. The "Listing Rules" stipulate that related party transactions of listed companies refer to the transfer of resources or obligations between listed companies, their subsidiaries under control and other entities under control and their related parties.

2.2. Definition of implicit associated relationships

In China's listed companies, related party transactions are very common and they are also the "hotspots" of financial fraud. However, with the continuous improvement of the accounting information disclosure system and the continuous strengthening of market supervision, the act of financial fraud through ordinary related party transactions can easily be identified by auditors with certain experience. Therefore, implicit related party transactions have become a common means for listed companies to conduct financial fraud through related party transactions.

From the previous content, it can be seen that the relevant documents such as "Enterprise Accounting Standards", "Listing Rules", and "Company Law" clearly define the definitions of related parties and related party transactions. However, there are no clear definitions for implicit related parties and implicit related party transactions by all parties. Currently, the generally accepted view in the academic community is as follows: An implicit related party refers to a natural person or enterprise that uses legal loopholes of the listed company to intentionally blur the relationship of association, hide the association, and present that there is no association on the surface, but actually can exercise control; an implicit related party transaction refers to the behavior of transferring resources, labor, or obligations by "de-associating" through the use of implicit related parties (Huang Shizhong et al., 2024; Guan Lian, 2018; Liu Xu, 2019) ^[2-4].

Implicit related parties may be the un-disclosed legal related parties that should be disclosed, namely the related parties listed in the Accounting Standards and Listing Rules mentioned earlier; or they may be suspected related parties that have the nature of related parties but are not explicitly listed by regulations.

3. Current situation of fraud in implicit related-party transactions

This article searched in the "Violation Actions" column of the "Total Violation Information Table" in the Guotai Nanjing Database, and manually screened and sorted the data. The statistics show that from January 1, 2020 to December 31, 2024, there were a total of 1,864 violation incidents involving undisclosed related parties or related transactions, accounting for 17.07% of all violation incidents. Over the past five years, there have been numerous incidents of financial fraud through implicit related party transactions. The number reached its peak in 2022, and the situation improved slightly in the following two years, but the nature remained relatively serious, becoming a problem that urgently needs to be addressed. This also brings new challenges to accounting firms and auditors.

Meanwhile, this article selected listed companies from 2020 to 2024 from the "CSRC Administrative Penalty Information Table" in the Guotai Nan Database. By searching the "violation behavior" column and conducting manual data screening and sorting, a total of 265 listed companies involving hidden related-party transactions from 2020 to 2024 were obtained. The "penalty method" was statistically analyzed. The obtained data indicate

the following characteristics of the current regulatory approach of the CSRC towards hidden related-party transactions. The penalty measures are concentrated and relatively simple, mainly consisting of fines and warnings, accounting for over 80%; at the same time, the punitive strength is generally insufficient, with a high proportion of economic penalties but low amounts, and the number of deterrent measures such as

market ban is less than 3 times per year on average. This "low-cost, low-risk" regulatory situation objectively reduces the cost of corporate violations. The potential gains for listed companies through hidden related-party transactions for fraud are much higher than the cost of illegal activities. In addition, the lag in identifying concealed transactions and the difficulty in obtaining evidence from external supervision provide convenient conditions for enterprises to engage in hidden related-party transactions, further intensifying the motivation of enterprises to take risks.

4. Fraudulent means of implicit related-party transactions

4.1. Domestic and foreign research

Some scholars in the domestic academic circle have conducted analyses and studies on the covert connected transaction methods employed by listed companies (Guan Lian, 2018; Hong Jinming and Liu Jiejun, 2019; etc.)^[3,6]. Currently, the classification proposed by Hong Jinming and Liu Jiejun (2019)^[6] is widely recognized by the domestic academic community. They categorize the covert connected transaction methods into five main types, using a third party as a transitional entity to complete indirect related-party transactions, associating parties disassociate themselves after the transaction, conducting related-party transactions in advance with future related parties, dividing the transaction amount into multiple transactions below the inspection threshold, and using implicit social relationships for de-association.

The research conducted by foreign scholars in this field is relatively scarce. Elaine et al (2007)^[7] summarized several covert forms of related-party fraud employed by listed companies, including fictitious related-party transactions, concealment of related-party relationships, abnormal fund occupation and guarantees among related parties, etc.

4.2. Summary of literature review

Based on the above-mentioned literature, especially the study of the literature of Huang Shizhong (2024)^[1], Hong Jinming and Liu Jiejun (2019)^[6], etc., this paper summarizes the common methods of implicit related-party transactions as follows.

4.2.1. De-association of association relationships

Individuals who have close ties with the company's controllers or senior executives will not be listed as affiliated companies at the financial reporting level. However, they can collude with the company and plan together to achieve goals such as whitewashing the financial statements. This is also the most common method used by enterprises to commit fraud through implicit related-party transactions. Zixin Pharmaceutical established undisclosed affiliated companies such as Tonghua Zhiyuan and Tonghua Hongtao to fabricate ginseng purchase and sales transactions, thereby inflating revenue and profits. These companies seemingly have no equity connection, but in reality, they are controlled by the controllers of Zixin Pharmaceutical through relatives, friends, or employees acting as proxies.

4.2.2. De-related-party transactions - utilizing third parties for bridging

First, conduct unfair transactions with non-related parties to achieve the performance targets, and then have the related parties negotiate with the non-related parties to make certain compensations for the transactions; or transfer resources to non-related parties at an unreasonable low price, and then have the non-related parties transfer the resources to the related parties for benefit transfer.

The former general manager of Dalian Beilang Co., Ltd., Gong Mingcheng, through forging resolutions and bypassing the assessment process, sold 67% of the state-owned equity of its wholly-owned subsidiary at a low price to an unrelated private enterprise. He also "bundled" and sold high-quality assets such as land and oil depots at a low price. Dalian Beilang Co., Ltd. provided a loan of 564 million yuan to the transferee for the purpose of acquiring its own assets, forming a closed loop of "grabbing the empty bag and getting the money". Subsequently, the transferee sold the low-priced acquired assets at a high price, making a profit of 171 million yuan. Among this, 106 million yuan was transferred to the affiliated private enterprise.

4.2.3. De-association of related-party transactions-de-association after completed transaction

After conducting a large number of transactions with related parties, the shares of the related parties were transferred before the financial statement date in order to achieve the "de-alignment" of the transactions.

Tianjin Magnetic Card originally held 94% of the equity of Tianjin Global Company. In 2001, it transferred its equity twice, reducing its shareholding to 47%, and then further withdrew completely. During this period, Tianjin Magnetic Card sold products to Tianjin Global Company at high prices, with a transaction amount of 215 million yuan. Through the equity transfer, Tianjin Global Company changed from an affiliated party to a non-affiliated party. This transaction did not require consolidation of financial statements and was not subject to the restrictions of the related party transaction pricing rules, thereby artificially inflating profits.

4.2.4. De-related-party transactions-conducting related-party transactions with future related parties in advance

Beforehand, negotiate with future counterparties to conduct transactions aimed at presenting favorable financial statements. Only after this do the counterparties become associated parties, thereby evading the inspection of associated party transactions.

A pharmaceutical company listed on the stock market paid several hundred million yuan in advance to a small raw material supplier in 2017, claiming that it was for "locking in the supply of raw materials". One year later, the supplier was acquired by the company's major shareholder at a high price and became a subsidiary. The high advance payment before the acquisition was actually provided by the major shareholder to fund the acquisition, and the subsequent association was used to cover up the illegal transfer of benefits. The regulatory authorities investigated and found that the transaction price of the advance payment was significantly different from the market price, and the supplier's qualifications were questionable. Eventually, it was determined that they used "future related parties" to evade their disclosure obligations.

5. Audit countermeasures for implicit related-party transactions

5.1. Strengthening professional skepticism and professional competence

Auditors should always maintain professional skepticism, remain vigilant towards abnormal transactions (such as large prepayments and transactions deviating from the main business), and conduct further audit procedures. They should enhance their professional capabilities in identifying covert related-party transactions and understanding the causes of audit failures by regularly studying cases of fraud.

5.2. Deepening identification of related parties

The identification scope should go beyond the legally required disclosure and extend to implicit related parties such as individuals or entities that have a significant influence on the management. In-depth investigation of the equity structure, the background of senior management, and interpersonal networks is necessary. Information sources such as industrial and commercial big data and internal enterprise documents should be comprehensively utilized for cross-validation to uncover potential connection clues.

5.3. Deep application of data analysis and technical means

According to the research conducted by Huang Shizhong et al. (2024)^[1,2], it is necessary to actively utilize technical tools such as association graphs, by analyzing common individuals and common contact information (such as addresses and phone numbers), to automatically construct a relationship network for identifying potential associated groups. At the same time, tools like SQL and Python can be used for multi-dimensional data analysis to discover abnormal transaction patterns.

5.4. Optimize auditing methods and combine multiple auditing procedures for use

Comprehensively apply analytical procedures (such as longitudinal, lateral and non-financial data comparison), and conduct inquiries in conjunction with contract verification and on-site observations. Additionally, strictly control the confirmation process and implement alternative procedures such as post-period fund flow tracing for unreturned confirmations and other abnormal situations, in order to obtain valid audit evidence.

6. Conclusion

Hidden related-party transactions, due to their strong concealment and high difficulty in identification, have become a common means of financial fraud in listed companies, seriously damaging the quality of information in the capital market and the interests of investors. This article, through a systematic analysis of its definition, fraud methods and auditing difficulties, finds that the current supervision has problems such as insufficient penalty intensity and single means, making it difficult to form an effective deterrent. Auditors should enhance professional skepticism, expand the scope of related party identification, deeply integrate big data and technical tools, and optimize the combination of audit procedures, thereby improving the effectiveness of auditing hidden related-party transactions. In the future, it is still necessary to further improve the information disclosure system, increase the cost of violations, and promote the collaborative innovation of auditing technology and regulatory models to effectively curb the fraud of hidden related-party transactions.

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