

## COMMENT

# Investors should speak out against self-dealing

## Why do executives often own the land next to the plant?

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Last month I wrote that self-dealing was one of the top three blights on the Canadian market, alongside insider trading and accounting shenanigans. Self-dealing is essentially what happens when so-called related-party transactions go bad.

There are many types of related-party transactions. An executive might own land that is leased to his public company employer, a director's firm might provide legal services to the company, or an executive might own a private company that provides services to the public entity. Most slippery in my experience; though, are one-off transactions where assets are being bought and sold by executives or directors.

Related-party deals should be carried out at fair market values. Frequently, however, they are not. Being a forensic accountant, I have had the luxury of examining some very rotten transactions, after the fact, from the inside out. The post-mortem, in many cases, is not good news for investors, and it's a shame I can't share the privileged details.

In this day and age, investors could be forgiven for thinking that related-party transactions only take place on terms to which sensible, arm's-length negotiators would agree. Unfortunately, our financial statement accountants and auditors see no need for this kind of requirement. In fact, they seem more than willing to make it easy for companies to hide pertinent details from investors.

The accounting rules state that related-party deals might be done at fair value, or they might not. Furthermore, it's up to com-

pany management to identify the related-party transactions that are to be included in the financial statements.

According to the accounting rules, "exchange amount" means "the amount of consideration paid or received as established and agreed to by related parties." In short, your left hand and right hand can have a conversation and agree that \$1-billion sounds nice. End of story. You've just complied with the full extent of our current financial reporting requirements.

While the magnitude of such transactions continues to rise, our financial reporting and auditing requirements have barely advanced. Even the most basic questions are not being pursued, such as why operating services, beyond general corporate management, have to be acquired from a company that is owned by an executive, instead of a third party.

Likewise, why does it seem that executives frequently own the land adjacent to the factory that the company needs to expand?

### IT'S UP TO INVESTORS TO SEEK DETAILS OF RELATED-PARTY DEALS

Was it knowledge gained while working for shareholders that led the executive to such a prescient side-purchase in the first place?

Anyone who thinks they're not affected by potential self-dealing should think again. Even if you don't own stocks or mutual funds or have a company pension plan, you could still be getting screwed as a consumer, if for example, the company you're buying from overpays for executive services or assets, and then passing the inflated costs on to you.

The most telling issue perhaps is when a company's financial statements don't confirm that a transaction was indeed carried out at fair market value. There's

not much that should get in the way of making such a claim... provided it's true of course.

The typical response from the accountants to this problem is that the fairness of related party deals is a governance issue. While true, this doesn't preclude the accountants from making financial reporting rules that benefit investors, while requiring little extra effort from the companies. After all, directors should have done their homework, and should have the independent evidence to confirm that a deal was done at fair value. So, why the pushback unless transactions are being done on unfair terms?

To be sure, the auditors are the second line of defence after the board of directors. But it's clear that investors need as much help as they can get, instead of finger pointing and skirting of responsibilities.

The third line of defence, our securities regulators, also fails to sufficiently protect investors from self-dealing. If there is one particular aspect of self-dealing on which the securities commissions should focus, it's when minority shareholders are being bought out by, or are being forced to purchase assets from, controlling shareholders at unfair prices. Weak directors armed with conflicted third-party fairness opinions are not providing investors with enough protection.

If I happened to have \$50-million for legal defences, I'd be happy to name Canadian empires that have been built on the backs of oppressed minority shareholders, while also unfairly enriching executives. Even so, it's highly questionable whether our securities commissions would do anything with the information.

In any event, with weak financial reporting and poor regulatory enforcement, it's up to investors to seek out the details of related party deals to see whether they've been carried out above board. It's no time to get lazy and assume that someone else has already asked the important questions.

Complacent owners are a greedy manager's best friend. Simply put, if investors get a whiff of something they don't like, there's probably more where that came from, and it's time to move on.

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