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Shareholder Rights and the Equitable Treatment of Shareholders

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Defining and Disclosing Related Party Transactions: A Survey of International Practices

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1. INTRODUCTION

Related party relationships are a normal feature of commerce and business. For example, enterprises frequently carry out separate parts of their value-chain activities through subsidiaries, joint ventures or associated companies and acquire interests in other enterprises for investment purposes or for trading reasons. Parties are considered to be related if one party has the ability, either directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subjected to common control or common significant influence. In other words, related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. Examples of related parties include:

- A parent company and its subsidiaries/associates/affiliates
- Subsidiaries/associates/affiliates of a common parent
- An enterprise and trusts for the benefit of employees such as pension and profit sharing trusts that are managed by or under the trusteeship of the enterprise's management
- An enterprise and its principal owners, management, or members of their immediate families

Some examples of common types of related party transactions are: sales, purchases and transfers of realty and personal property; services received or furnished (eg: accounting, management, engineering and legal services); use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; inter-company billings based on allocations of common costs and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and thus not record receipt of the services.

The existence of a related party relationship may expose a reporting entity to risks or provide opportunities, which would not have existed in the absence of the relationship. Related party relationships may therefore have a material effect on the financial performance, financial position and financing and investing of a reporting enterprise. Related parties may enter into transactions, which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties (eg: a subsidiary may be instructed by its parent not to engage in research and development activities).

Generally Accepted Accounting Principles (GAAP) concerning disclosures require that financial statements (1) include all relevant and material information in the financials or footnotes and (2) not be misleading. International Accounting Standard, IAS 24 "*Related Party Disclosures*" requires

disclosure of related party relationships (where control exists) irrespective of whether there have been transactions between related parties. However, IAS 24 does not require disclosure in parent entity accounts of items eliminated on consolidation. Different countries have employed multiple and alternative approaches and regulations, which may or may not comply with IAS 24 to account for and disclose related party transactions. This report will summarize the views and different methods used in disclosing and accounting for related party transactions in U.S.A, U.K, Australia, Hong Kong and Singapore respectively.

LEGAL AND REGULATORY FRAMEWORK FOR DISCLOSURE OF RELATED PARTY TRANSACTIONS

Identification of ‘Related Parties’

As alluded to above, there are many ways that a party may be ‘related’ to a corporate entity. The Appendix below illustrates the numerous possibilities found in the various terminology and definitions used to describe such relationships. For any law or regulation pertaining to disclosure of related party transactions to have any effect however, a framework must be in place for those monitoring or policing the matter to be able to examine whether or not any such relationship exists between transacting parties. All common law jurisdictions therefore have a system in place to both capture relevant information and to make such information readily available. There are four main sources of such information.

First, legislation in all common law jurisdictions requires information to be filed with a central registry maintained by governmental authorities. Particulars of directors, managers, corporate secretaries, auditors and other officers as well as changes in appointments must be promptly filed with these registries. Secondly, companies are required to maintain up-to-date registers with details of members, substantial shareholders, directors and their shareholdings, debenture holders, persons who have interests other than shares and debentures etc. All these registers are open for inspection to shareholders and members of the public on payment of a nominal fee. Thirdly, where the company is listed on the stock exchange, it is required to furnish to the relevant exchange information relating to its directors, key managers and substantial shareholders. Finally, much of the information about who may be ‘related’ to the company may be found in annual reports that have to be prepared and furnished to shareholders.

Disclosure of related party transactions

The legal and regulatory framework for disclosure of related party transactions is made up of requirements under the general common law, corporate legislation and quasi-legislative requirements such as exchange rules and accounting standards.

Under the common law

Requirements for disclosure of related party transactions under the common law primarily concern directors (including ‘shadow directors’ – ie persons who are themselves not formally appointed as directors but who exercise such control over the board such that the board is accustomed to act in accordance with that person’s instructions). This stems from the directors’ fiduciary duty not to place themselves in a position where their interest may possibly conflict with that of the company of which they are directors. A director who transacts with the company is obviously in a potential conflict situation. The transaction must be disclosed to the shareholders and approved by them through a shareholders’ resolution in a general meeting. Should the transaction proceed without appropriate disclosure, the company will have the option avoiding the transaction. Alternatively, it is open to the company to adopt the transaction and to take out a civil suit against the director for any loss that the company has suffered or any profit that the director may have gained from the transaction. The breach may also result in the director being removed from office.

Because of the administrative costs and inconvenience of having to seek shareholder approval, it is common to find an express provision in the constitutional documents of a company giving a blanket approval for directors to transact with the company subject to appropriate disclosure to, and approval of, the company’s board of directors. The director concerned is usually prohibited from voting in the circumstances. Should this be done, it is up to the other directors of the company to exercise their fiduciary duties and act in the best interests of the company in deciding whether or not to proceed with the transaction.

There is no common law rule requiring other related parties (eg senior managers, substantial shareholders etc) to make similar disclosures when they transact with the company. Should such a transaction be contemplated, the burden again falls on the directors of the company to ensure that the interests of the company are not prejudiced.

Under Corporate Legislation

Corporate legislation vary greatly, even among countries, which share the same common law heritage and the same predecessor legislation. The key differences between disclosure requirements under the common law and under corporate legislation are that the latter are usually more specific and carry criminal or penal sanctions. In Singapore, for example, there is a specific provision requiring directors who are in any way, whether directly or indirectly, interested in a contract with the company to declare the nature of the interest at a meeting of directors as soon as is practicable after being made aware of the relevant facts. Failure to comply with this provision is a criminal offence. In addition, there are provisions that prohibit specific transactions such as loans to directors or to director-related companies in prescribed circumstances. The need to furnish members with an annual report and audited accounts is also mandated by corporate legislation. This, together with the relevant accounting

standards (discussed below), also facilitates the capture of information about related party transactions and the reporting of such information to existing shareholders.

The common law rules and the provisions of the corporate legislation are primarily for the benefit of existing shareholders. They either provide a civil remedy where the company is prejudiced as a result of the transaction or prescribe criminal sanctions as a deterrent against undisclosed / unapproved transactions or transactions that are out-rightly prohibited. These laws are generally applicable to all companies regardless of their size. The focus is not so much on disclosure *per se* but more to ensure the acquiescence of existing shareholders of the transactions.

Quasi-legislative requirements

The final major source of regulation of related party transactions is from quasi-legislative sources such as stock-exchange listing requirements. There is an added concern when companies tap the capital markets for funds. The relevant information would need to be made available quickly to members of the investing public. As will be seen in the discussion below, listing requirements generally encourage or mandate immediate disclosure of significant related party transactions either through the mass media or via the channels managed by the respective exchanges. Unlike the common law and legislation, the focus of listing requirements is on relevant, accurate and timely disclosure of the transactions while maintaining the emphasis on the need for shareholder mandate for selected transactions. Key aspects of the disclosure requirements of selected stock exchanges are outlined in the next section.

2. AN OVERVIEW OF INTERNATIONAL PRACTICES IN ACCOUNTING STANDARDS AND LISTING REQUIREMENTS RELATING TO DISCLOSURE OF RELATED PARTY TRANSACTIONS

United States of America

In the US, The Financial Accounting Standard Board, FASB Statement No. 57, “*Related Party Disclosures*”, provides guidance on the disclosure of transactions with related parties. FASB Statement No. 57 states that financial statements must include disclosures of material related party transactions in addition to compensation arrangements, expense allowances and other similar items in the ordinary operation of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in the statements. The disclosures must include:

- a) The nature of the relationships involved.
- b) A description of the transactions (including transactions where no prices are charged) and other information that are necessary for an understanding of the effects of the transactions on the financial statements.

- c) The dollar amounts of the transactions and the effects of any change in the method of establishing the terms from that used in the preceding period.
- d) Amounts due from or to related parties and the terms and manner of settlement

FASB Statement No. 57 also specify that transactions involving related parties cannot be presumed to be carried out on an arm's length basis as the conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, may not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless those representations can be substantiated.

On January 22, 2002 (in view of the disclosure failures at Enron Corporation), the Securities and Exchange Commission (SEC) issued a release entitled "Commission Statement about Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations" (SEC Release No. 34-45321) (the "Release"). The release instructs companies in disclosing related party transactions that they should include a description of all elements of the transaction necessary for an understanding of its business purpose, its effect on the company's financial statements and special risks or contingencies arising from the transaction. Additionally, the company should consider disclosing the identity of the related parties; how the transaction price was determined; how any evaluation of fairness was made and whether there are any ongoing contractual or other commitments as a result of the transaction.

New York Stock Exchange (NYSE), Listed Company Manual Section 307.00 "*Related Party Transactions*" states that there should be expanded disclosure of related party transactions in the company's annual report and proxy statements as well as in other corporate filings. However, the Exchange recognizes that the company's management is in the best position to evaluate such relationship intelligently and objectively. Hence, the Exchange believes that the review and oversight of such situations is best left to the discretion of listed corporations and corporations applying for listing on the NYSE. Each related party transaction is to be reviewed and evaluated by an appropriate group within the listed company involved. While the policy does not specify who should review related party transactions, the Exchange believes that the Audit Committee or another comparable body might be considered appropriate for this task. Following the review, the company should determine whether or not a particular relationship serves the best interest of the company and its shareholders and whether the relationship should be continued or eliminated. The Exchange will continue to review proxy statements and other SEC filings disclosing related party transactions and where such situations continue year after year, the Exchange will remind the listed company of its obligation on a continuing basis to evaluate each related party transaction and determine whether or not it should be allowed to continue.

It is important to note that there are certain related party transactions that require shareholder approval under the Exchange policy. NYSE Listing Company Manual Section 312.00 "*Shareholder Approval Policy*" should therefore be done in tandem with any consideration of the matters covered in Section 307.00. Shareholder approval is required in the following situations:

a) prior to the issuance of common stock or of securities convertible into or exercisable for common stock to:

- a director, officer or substantial shareholder of the company
- a subsidiary, affiliate or other closely-related person of a related party
- any company or entity in which a related party has a substantial direct or indirect interest

if the number of common stock to be issued, convertible or exercisable exceeds either 1% of the number of common stock or 1% of the voting power outstanding before the issuance.

However, if the related party involved in the above transactions is classified as such solely because such person is a substantial shareholder and if the issuance is at a price as great as the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of common stock to be issued, convertible or exercisable exceeds either 5% of the number of common stock or 5% of the voting power outstanding before the issuance.

b) prior to the issuance of common stock, or of securities convertible into or exercisable for common stock if:

- the common stock has equal to or greater than 20% of the voting power outstanding before the issuance
- the number of common stock to be issued is equal to or greater than 20% of the number of common stock outstanding before the issuance

c) prior to an issuance that will result in a change of control of the issuer

However, shareholder approval will not be required for issuance involving:

a) any public offering for cash

b) any bona fide private financing if such financing involves a sale of:

- common stock for cash at a price greater than the book and market value of the issuer's common stock
- securities convertible or exercisable for common stock for cash if the conversion or exercise price is greater than the book and market value of the issuer's common stock

United Kingdom

In the UK, the Accounting Standards Board (ASB) issued the Financial Reporting Standards, FRS 8 “*Related Party Transactions*” which provides guidance on disclosing related party transactions. According to the ASB, a standard on related party disclosures is needed because users of financial statements are entitled to assume that transactions have been effected on an arm’s length basis. However, the existence of related parties will result in transactions being effected other than on an arm’s length basis. Therefore the objective of FRS 8 is to disclose the existence of related parties and the nature and extent of any transactions with them. It is notable that FRS 8 does not seek to regulate the transactions themselves, merely their disclosure. Thus, FRS 8 is seeking to identify parties that are bound together by control or influence as it is in such circumstances that one party might enter into a transaction under terms and conditions that are not in its best interests.

Once a related party relationship has been established, the question of disclosure arises. FRS 8 requires two parts of disclosure; disclosure of control and disclosure of transactions. (1) Disclosure of control: Where the reporting entity is controlled by another party, there should be disclosure of the related party relationship and the name of the related party and the controlling party. This information should be disclosed irrespective of whether any transactions have taken place between the parties. This is because the existence of control immediately means that the reporting entity is not automatically able to pursue its own best interests. An underlying principle of the FRS 8 is that a user needs to know this information. (2) Disclosure of transactions: Unless the transaction is covered by one of the exemptions which we will consider in the next section then if the related parties carry out transactions with each other (whether or not at arm’s length) details of the transaction should be given in the financial statements as shown below:

- 1) The names of the transacting related parties and a description of the relationship between them.
- 2) A description of the transactions and the amounts involved, together with any other elements of the transactions necessary for an understanding of the financial statements (eg, if the transaction were carried out otherwise than on an arm’s length basis).

- 3) The amounts due to or from related parties at the balance sheet date and any provisions for doubtful debts due from such parties at that date.
- 4) Amounts written off in the period in respect of debts due to or from related parties.

The overall purpose of the disclosures is to give a user an appreciation of the effect of related party transactions on the financial statements. It should be fairly clear why most of the disclosures are needed. Disclosure (4) above might merit further explanation. This disclosure is deemed necessary because writing off amounts owed by a related party might turn a transaction on normal arm's length terms into one that is 'unusual'.

However, FRS 8 does not require disclosure of the following related party transactions:

- a) in consolidated financial statements, of any transactions or balances between group entities that have been eliminated on consolidation
- b) in a parent's own financial statements when those statements are presented together with its consolidated financial statements as any related party transactions with the parents and group entities would have already been captured or eliminated in the consolidated financial statements
- c) in the financial statements of subsidiary if 90% or more of whose voting rights are controlled within the group
- d) in the financial statements of subsidiary for transactions with entities that are part of the group or investees of the group, provided that the consolidated financial statements in which the subsidiary is included are publicly available
- e) of pension contributions paid to a pension fund
- f) of emoluments in respect of services as an employee of the reporting corporation

If the reporting entity has relationships and transactions with:

- providers of finance in the ordinary course of their business
- utility companies
- government departments and their sponsored bodies
- customers, suppliers, franchisers, distributors or general agents with whom the entity transacts a significant volume of business

then, no disclosures of any kind are required. This exemption is included because to do otherwise would render the potential network of related parties of organizations included in the list almost

limitless. (eg: you could argue that a bank, often being the sole or main provider of finance, exercises control or influence over every small business customer on its books. It would clearly be impracticable to expect all such transactions to be disclosed in the financial statements of either the bank or the customer.) It is clear that a number of the requirements of FRS 8 are extremely subjective to apply. This is particularly so in the identification of related parties. Therefore, shortly following the October 1995 publication of FRS 8, the Auditing Practices Board (APB) published SAS 460, “*Related Parties*” which serves as a toolkit in helping accountants and auditors in complying with related party auditing and accounting standards. The guidelines in SAS 460 include the following:

- a) Tests as specified in the audit plan are correctly conducted, the results properly recorded and conclusions validly drawn.
- b) The existence, completeness, ownership, valuation and description of assets and liabilities is established and supported by appropriate evidence.
- c) All matters of an unusual nature are identified and promptly referred to the audit supervisor.
- d) Material and significant errors, deficiencies or other variations from standard are identified, recorded and reported to the audit supervisor.
- e) The IT environment is examined and assessed for security.
- f) Discussions with staff operating the system to be audited are conducted in a manner that promotes professional relationships between auditing and operational staff.
- g) Confidentiality and security procedures are followed.

Transactions with related parties are governed by Chapter 11 of the UK Listing Authority’s Listing Rules. A transaction with a related party is defined as a transaction between a company, or its subsidiary, with a related party or a party which exercises significant influence over the company. It also includes any arrangement pursuant to which the company or its subsidiary and a related party each invests in, or provides finance to another undertaking or asset. A company that intends to enter into a related party transaction is required to consult the UK Listing Authority should there be any doubt as to whether the transaction falls within the ambit of the Chapter. A copy of the proposed contract must be furnished to the Authority if requested.

Where a company proposes to enter into a related party transaction, it must do the following:

- make an announcement in the prescribed manner stating the details of the transaction, the name of the related party concerned and the details and nature of the interest of the related party in the transaction;

- furnish its shareholders with a circular containing the prescribed information about the transaction;
- obtain shareholder approval prior to the transaction or, if the transaction is stated to be conditional upon such approval, prior to the completion of the transaction; and
- where applicable, ensure that the related party and its associates refrain from voting in the resolution pertaining to the transaction.

Transactions that are exempted from these requirements include:

- transactions by companies without listed securities;
- transactions by overseas companies with a secondary listing ;
- specified issues of new securities and employee share schemes;
- the giving of credit on normal commercial terms and other transactions of a revenue nature in the ordinary course of business;
- joint investment arrangements which are, in the opinion of an independent advisor acceptable to the Authority, no less favourable than those applicable to the related party; and
- small transactions (defined as less than 0.25% of specified ratios).

There is also no need for full compliance in cases where the transaction exceeds 0.25% of certain specified ratios but which are below 5% of the ratios. In such circumstances, all that is required is that the company furnish the Authority with details of the proposed transaction in writing and provide them with written confirmation from an acceptable independent adviser that the terms of the proposed transaction with the related party are fair and reasonable to the shareholders of the company. The company must also furnish a written undertaking to include details of the transaction in the company's next published annual accounts.

Australia

The Australian Accounting Standard Board, AASB 1017 "*Related Party Disclosures*" prescribe disclosure by all corporate reporting entities of related party relationships, transactions and balances where the relationship arises through the control or significant influence of entities. AASB 1017 also apply to disclosures in respect of directors of corporate non-disclosing entities as for a non-disclosing entity, the corporation is not required to disclose any related party transactions, thus, the directors themselves have to disclose any dealings with related parties required under AASB 1017. However,

disclosures of directors of a disclosing entity will be exempted from AASB 1017 since the corporation is required to disclose all related party transactions. Under AASB 1017, a corporation is a disclosing entity if its securities are listed on a stock exchange, it has issued (under a prospectus) securities to more than 100 shareholders or it is a borrowing corporation with more than 100 debenture holders. To harmonize with IAS 24, a reference to disclosure of pricing policies relevant to transactions has been included in AASB 1017. The current disclosure requirements for transactions within the wholly owned group are less detailed than those applicable to transactions with other related parties. In addition, parent companies are required to disclose items eliminated on consolidation although IAS 24 exempts such items from disclosure. The disclosures must include the following:

- identity of the related party involved
- each type of transaction of different nature
- the terms, conditions and amount of each type or where there are different categories of terms and conditions within each type, the terms and conditions of each category.

Information is normally aggregated by classes of related party within each type of transaction or where there are several categories within a type. Where a reporting entity has transactions with a particular class of related party and the transactions were of different types (eg: supply of raw materials and purchase of management services), it is necessary to identify each different type of transaction considered relevant to users of the financial statements and disclose the terms and conditions including pricing policies. Where the reporting entity has transactions of the same type with a particular class of related party, some of which have been arranged under one set of terms and conditions and others under a different set of terms and conditions (eg, some on a normal commercial basis and others free of charge), the differences give rise to different categories within that type. Disclosure on an individual basis is required when there are several transactions with a particular class of related party that are not individually material but the sum of the transactions is significant.

Knowledge of the nature of related party transactions and the relationship between the transacting parties is likely to affect the perceptions held by users of the financial report with respect to the risks and opportunities facing a reporting enterprise. Accordingly, a reporting entity is required to disclose all transactions and balances with related parties, whether normal or not. Transactions are excluded from the disclosures when:

- a) they occur within a normal employee, customer or supplier relationship on terms and conditions no more favourable than if dealing with an unrelated individual or/and
- b) information about them does not have the potential to adversely affect decisions made by users of the financial report or the discharge of accountability by the directors

Whether a related party relationship exists needs to be determined in the light of the prevailing circumstances. In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely its legal form.

In Australia, related party transactions are also governed by the Corporations Law, Chapter 2E, which is created specifically to protect shareholders' interest. Section 208 of the Corporations Law provides the following guidelines that corporations must comply with:

- shareholders' approval is required for giving financial benefits to related party unless the transaction is covered by one of the exemptions which we will consider below
- the transactions must take place within 15 months after approval

Section 229 of the Corporations Law defines giving a financial benefit to a related party as:

- giving or providing the related party finance or property
- buying an asset from or selling an asset to the related party
- leasing an asset from or to the related party
- supplying services to or receiving services from the related party
- issuing securities or granting an option to the related party
- taking up or releasing an obligation of the related party

Under Section 210-216 of the Corporations Law, the following related party transactions are not subjected to shareholders approval requirements:

- if the transaction is at arm's length terms
- remuneration and reimbursement for employee
- indemnities, insurance premiums and legal costs
- small amounts (less than \$2,000) given to a director or their spouse
- benefit to or by closely-held subsidiaries

The Australia Stock Exchange, ASX Listing Manual Chapter 10 "*Transactions with persons in a position of influence*" deals with transactions between an entity (including its subsidiaries) and persons in a position to influence the entity. Transactions covered by this chapter include acquiring and disposing of substantial assets (5% or more of the equity interests of the entity including intangibles, goods, services). Shareholder approval must be obtained in respect of acquisitions or disposals of substantial assets to specified parties including related parties, subsidiaries, substantial shareholders and associates of these parties. The notice calling for the meeting for approving such transactions must contain, amongst other things, a report on the transaction from an independent expert. The report must state all the transaction details and whether the transaction is fair and reasonable to the entity's shareholders. The following are exempted from this requirement:

- a transaction between the entity and a wholly owned subsidiary
- a transaction between wholly owned subsidiaries of the entity
- an issue of securities by the corporation for cash
- a transaction between the entity and a person who is a related party by reason only of the transaction

The chapter also deals with the issue of securities to related parties. Such issues must also be mandated by shareholders at a shareholders' meeting. The notice calling for such a meeting must include the following:

- the name of the person
- the number of securities to be issued to the person
- the date by which the entity will issue the securities which must not be more than 1 month after the date of the disclosure
- a statement of the relationship between the person and the director (or entity) which requires approval to be obtained
- the issue price of the securities and a statement of the terms of the issue
- a voting exclusion statement
- the intended use of the funds raised

The exemptions to the above rule are as follows:

- the person receives the securities under an underwriting agreement or on a pro-rated basis
- the person receives the securities under an employee incentive scheme with approval under that rule
- the person receives the securities under an off-market bid that was required to comply with the Corporations Act or as part of a merger under Part 5.1 of the Corporations Act
- the person receives the securities on the conversion of convertible securities
- the value of the securities to be received by the person plus the total value of securities received by this person under this exception in the 12 months before the date of issue is not more than \$3,000
- an issue under an agreement (must be in compliance with the listing rules) to issue securities
- an agreement to issue equity securities that is conditional on shareholders approval

Hong Kong

The Hong Kong Society of Accountants' (HKSA) Statement of Standard Accounting practice (Statement 2.120, "*Related Party Transactions*") is closely modeled after IAS 24 and FASB Statement No. 57. Under the standard, the reporting enterprise should disclose the nature of all the related party relationships (normal or not normal) as well as the types and the elements of the transactions necessary for an understanding of the financial statements, which would normally include:

- an indication of the volume of the transactions (either as an amount or as an appropriate proportion)
- amounts or appropriate proportions of outstanding items and pricing policies.

Transactions between related parties cannot be presumed to be effected at the same terms as between unrelated parties. Items of a similar nature may be disclosed in aggregate except when separate disclosure is required by law or is necessary for an understanding of the effects of related party transactions on the financial statements. Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding company and subsidiaries as a single reporting enterprise.

The Stock Exchange of Hong Kong Limited Listing Rules Chapter 14 “*Notifiable Transactions*” Rules 14.23 to 14.32 sets out the circumstances in which listed companies are required:

- a) to disclose details of “Connected transaction”
- b) in the case of certain material transactions or transactions with connected persons, shareholders’ approval is needed

The rules distinguish between three categories of “Connected transactions”. Rule 14.24 governs transactions that are not normally subject to any disclosure or shareholders approval requirements. These include::

- a) the acquisition of goods or services by a listed issuer (or any of its subsidiaries) from or to a connected person in the ordinary course of business on normal commercial terms
- b) a transaction between two or more listed issuers (or any of its subsidiaries) which involves the sharing of services or other similar arrangements on normal commercial terms in the ordinary course of business
- c) a transaction between a listed issuer and any of its wholly owned subsidiaries or between wholly owned subsidiaries of the listed issuer or between wholly owned subsidiaries of any of the issuer’s non wholly owned subsidiaries provided that:
 - o the transaction is on normal commercial terms in the ordinary course of business
 - o no connected persons are together a substantial shareholder in any of the subsidiaries involved
- d) any transaction on normal commercial terms which is less than the higher of either;
 - o HK\$1,000,000 or
 - o 0.03% of the book value of the net tangible assets of the listed issuer

However, it must be noted that the above transactions may not necessary be exempted from other aspects of the exchange’s corporate disclosure policy, and in particular, those pertaining to very substantial acquisitions, material transactions and disclosable transactions (rules 14.06 to 14.19). The second group of connected transactions pertains to transactions, which are normally subject only to disclosure requirements. Examples of such transactions are found in Rule 14.25. Depending on the transaction concerned, details pertaining to the transaction are to be disclosed either in the issuer’s

next published annual report and accounts or through a press notice in addition to disclosure in the report and accounts. Rule 14.26 lists the transactions that may be entered into only if they are made conditional on the obtaining of approval of the shareholders in general meeting. An undertaking that any connected person interested in the transaction shall abstain from voting at the meeting must also be furnished. The full particulars of such transactions must be disclosed via circular to shareholders and furnished to the Exchange for review.

The approach taken in Hong Kong is one of active consultation with the Exchange. Issuers are encouraged to consult the Exchange at an early stage to determine the necessary action to be taken in relation to any proposed connected transaction. The Exchange has the prerogative to grant issuers a waiver from any or all of the requirements relating to such transactions. Where a waiver is given in respect to shareholder approval, the Exchange will normally require a letter from the issuer's auditor or a financial advisor acceptable to the Exchange stating their opinion that the transaction is fair and reasonable so far as the shareholders of the company are concerned. It is usual for the Exchange to ask that the issuer still disclose the transaction via a press notice and publication in the issuer's next published annual report and accounts.

Singapore

Financial reporting in Singapore is largely influenced by the Companies Act (Chapter 50), the Income Tax Act (Chapter 134), the Listing Manual requirements of the Singapore Exchange (SGX) and the accounting pronouncements issued by the Institute of Certified Public Accountants of Singapore (ICPAS). Statement of Accounting Standards, SAS 21, issued by ICPAS requires disclosure of certain related party information. Specifically, SAS 21 states that all related party relationship involving control (eg: parent-subsidiary relationship) should be disclosed irrespective of whether there have been transactions between the related parties. If there have been transactions between related parties, SAS 21 requires disclosure of the nature of the related party transaction, the types of transactions (eg: sales, management fees) and the elements of the transactions (eg: pricing policy) necessary for the understanding of the financial statements.

Related party relationship, as defined in SAS 21, not only covers related companies as defined in Companies Act (including holding company, subsidiaries, sub-subsidiaries and fellow subsidiaries) and associated companies but also include individuals having significant influence over the reporting corporation and close members of family of such individuals; key management personnel of the reporting enterprise and enterprises owned by the same individuals or managed by same key management personnel. On the other hand, SAS 21 excludes the following from its definition of related party relationship:

- two companies simply because they have a director in common

- provider of finance
- trade union
- public utilities
- government departments and agencies
- a single customer, supplier, franchiser, distributor or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

Singapore Exchange (SGX) Listing Manual Chapter 9A “*Interested Party Transactions*” provides guidance for corporations listed or applying for listing on SGX on the disclosure of interested party transactions. The objective of this Chapter is to safeguard against the risk that interested persons could influence the listed issuer (its subsidiaries or target associated companies) to enter into transactions that may adversely affect the interests of the listed issuer and its shareholders, by requiring that, in general, transactions exceeding 3% of the issuer’s latest audited net tangible assets be disclosed immediately to the market through the making of an announcement in the prescribed manner. Similarly, if the aggregate value of all transactions entered into with the same interested person during the same financial year amounts to 3% or more of the issuer’s latest audited net tangible assets, the issuer must make an immediate announcement of the latest transaction and all future transactions entered into with that same interested person during that financial year. Transactions below \$100,000 are ignored for this purpose.

An announcement required under Chapter 9A must contain the following information:

- Details of the interested person transacting including the nature of that person's interest in the transaction
- Details of the transaction including the terms of the transaction and the bases on which the terms were arrived at
- The rationale for and benefit from transacting with an interested person
- A statement whether or not the audit committee (role is to protect the interests of minority shareholders) is of the view that the terms of the transaction are on normal commercial terms and are not prejudicial to the interests of the listed issuer's shareholders

Under SGX Listing Manual Chapter 9A, the following transactions are not interested person transactions regardless of the materiality of the transaction:

- payment of dividends, bonus issue, stock split, options or warrants granted under the preferential offer
- employees' share option scheme approved by the Exchange
- where the interested person's interest in the investee company, other than that held through the issuer, is less than 5% [eg of such relationship: (a) Where the listed issuer's director is also a director of the investee company but solely as a nominee of the listed issuer; (b) Where none of the substantial shareholders or directors of the listed issuer is a substantial shareholder of the investee company other than via the listed issuer's interest in the investee company.]
- where there are no other interested relationships except for common directorships and the directors who have common directorships have in aggregate less than 5% of the shareholdings in either the entity at risk or that other company
- where the other person is not also a substantial shareholder or director of the listed issuer.
- provision and receipt of financial assistance or services by a financial institution or a subsidiary of a financial institution that is licensed or approved by the Monetary Authority of Singapore (MAS) upon normal commercial terms in the ordinary course of business.
- director's fees and remuneration, and employment remuneration.

To further safeguard the interests of shareholders, the Listing Manual requires the issuer to obtain shareholder approval in respect of related-party transactions that individually or collectively exceed 5% of the issuer's audited net tangible assets. This may cause some administrative inconvenience for issuers that have regular business dealings with related parties which are necessary for its day to day operations. In these circumstances, it is permissible for the issuer to obtain a general mandate from its shareholders subject to appropriate disclosure via circular to shareholders, disclosure in the annual report and annual renewal.

Singapore Exchange Ltd (SGX) announced on 10 May 2002 that it has completed the review of the listing rules. The New Listing Manual, which includes key amendments designed to clarify and simplify obligations on listed issuers while retaining the essential requirements for a fair and orderly market took effect on 1 July 2002. The new SGX Listing Manual Chapter 9 "*Interested person transaction*" - The thresholds for determining whether an interested party transaction requires announcement and/or shareholder approval as well as the disclosure and shareholder approval processes and procedures have been streamlined. The underlying philosophy and the substantive requirements remain largely the same.

Recently, on 30 August 2002, SGX sets out proposed amendments to the listing rules in relation to the recommendations made by the Disclosure and Accounting Standards Committee (DASC) and continuing listing matters. Previously, only an opinion from the company's audit committee was required. Now, an opinion must also come from an independent financial adviser. Currently, Rule 917(4) requires an announcement of interested person transactions to contain a statement from the audit committee whether the transaction is on normal commercial terms and the terms are not prejudicial to the interests of the issuer and minority shareholders. This rule is amended to allow an issuer to indicate in its announcement that it will disclose the audit committee's views in a subsequent announcement. This is to allow the audit committee to obtain an independent financial adviser's opinion before forming its own views, which will be announced subsequently.

C. AN ASSESSMENT OF CURRENT PRACTICES AND CONCLUDING COMMENTS

Most of the accounting standard on related party transactions centers on the measurement and identification of related parties and related party transactions. However, it does not mean that identification is synonymous with disclosure. Although it is necessary to identify related party transactions in order for appropriate disclosure to occur but identification in itself is not sufficient to assure disclosure. Thus, it can be said that those standard considers identification of related parties, related party transactions and measurement but omit disclosure. It also seems that, generally, the issue of disclosure is under-represented in accounting standards in spite of the fact that disclosure is often the primary means by which the financial statements communicate information about related party transactions to the financial statement users. Accounting standards would be improved by focusing on the provision of assurance regarding the measurement and disclosure of related party transactions and organizing the standard around these two issues.

There is excessive reliance on "enquiry of management" to identify related parties. Hence, transactions with related parties can be manipulated and concealed by management either for corporate purposes or because fraudulent activity is involved. Given the importance and the risks of related party transactions, the auditor should always do some independent investigation. Thus, procedures such as searching for potential related parties in minutes of shareholders'/directors' meetings, shareholders' registers, correspondence with lawyers, etc. should be carried out in every audit. Once the auditor uncovers a related-party transaction, he or she has two additional responsibilities: 1) closely examine the transaction to make sure that it occurred and is correctly valued and 2) ensure the GAAP requirements are satisfied.

Often the accounting standard separates the identification of related parties and the identification of related party transactions as if they were distinct objectives. However, in reality, the identification of related parties is simply a necessary step in the process of identifying related party transactions. Thus, the identification of related parties cannot be seen as an end in itself, it is done only for the purpose of identifying and ensuring appropriate measurement and disclosure of related party transactions. In other words, the standard would be improved if the issues relating to identifying related parties could be discussed in the context of being one step in the process of identifying and ensuring appropriate measurement and disclosure of related party transactions.

Disclosure of related party transactions in financial statements may be opposed on the grounds that it will provide competitors with confidential data that may hurt the reporting entity. It is often argued that harm might come to the reporting entity through disclosure of details of related party transactions to government bodies such as income tax authorities, custom authorities and foreign governments. While this may be true to some extent, however, these bodies would usually have the right to obtain such information. Further, unless there is something to hide from these bodies about such transactions, there are no grounds for objecting to them. Also, it is possible that disclosure of related party transactions will suggest that there is something questionable about the transactions or the accounting for them. While this might be an initial reaction to such disclosure by the public, the fact that disclosure is required for all companies would tend to reduce the likelihood of such mentality and tend to ensure that the transactions were correctly accounted for. The perceived usefulness of financial statements disclosures must be weighted against the cost of making them. Disclosures that have a significant cost and that are viewed as of little or no value to the users (either because the information is already known by the users or because it is not relevant to their decisions) should not be required.

One of the main purposes of related party transactions for the enterprises is to shift income from high tax countries to low tax countries (the transactions are intentional efforts by corporations to avoid total worldwide income taxes because the transactions reduce income available for taxation). Similarly, corporations would set transfer prices for related party transactions in an attempt to minimize taxable income in the countries with high income tax rates [For example, by inflating the prices they paid to their foreign parents (with low tax rates) for goods, services and technology, local subsidiaries (with high tax rates) were able to reduce their taxable income and hence income taxes paid]. Hence, related party disclosures on the transfer prices (what and how is it being derived) are very important here to prevent the corporation from avoiding a country's income taxes.

Transactions with related parties may result in the following:

- create agency problems of opportunism and shrinking

- defraud the company
- derive personal benefits through abuse of the office held
- present false and misleading financial statements (window dressing or earnings management) in an effort to maintain the prosperity or ensure the survival of the company

Since the managers are evaluated, compensated and promoted on the basis of their performance in their respective divisions or subsidiaries, issues of the terms of transfers are significant and important. Managers will attempt to absorb for themselves as much as possible of the benefits of any transaction. One form of opportunism is adverse selection; a situation in which people behave in a way to penalize the trading partner (related party in this context). Moreover, not all related party relationships are so evident and transactions may be undertaken with the intention to deceive. Among the methods of achieving fraud is the siphoning off of assets through transactions with affiliated companies, kickbacks and irregular transactions between officers and related parties. Business structures and operating policies have sometimes been deliberately designed to obscure a related party. In this way, it is possible for undisclosed benefits to accrue to one or more of the related parties. Thus, company sometimes discourages related party transactions.

Nevertheless, companies within the corporate group at times benefit from their relationship and dealings with other companies within the corporate group due to the synergies/commonalities that exist between these companies or by facilitating more communication and interaction between these companies which will reduce information asymmetry and promote goal congruence. However, some appear to have the misconception that related party transactions are less valid or appropriate than those between unrelated parties. This misconception may have arisen in part from widely-publicized reports about cases in which related party transactions were used to obtain for one or more of the parties special (and sometimes even illegal) benefits which were not disclosed (eg; Enron case). It is unfortunate that the occurrence of such abuses has tended to taint all transactions between related parties, the great majority of which are legitimate and have a bona fide business purpose. A particular area of misunderstanding has been the assignment of prices to goods and services transferred between related companies in different countries. In order to be given accounting recognition, these transfers have to be valued – transfer pricing, a process often involving many perplexing theoretical and practical problems to which there are no readily apparent solutions or formulas in deriving them. Unfortunately, reports about differences of opinions regarding transfer prices have led some to the erroneous belief that transfer pricing is somehow evidence of devious motives on the part of the transacting parties and this in turn led to some companies discouraging related party transactions. However, over-regulating or discouraging related party transactions may have the undesirable effect of dampening dealings and transactions between related parties in the same corporate group even though such transactions may be in the best interests of shareholders (eg: lower costs of good quality

materials can be obtained from the parent company than from outside sources) and may represent the most efficient economic use of resources (helps the company to achieve economic of scale, learning effect etc). In addition, an over-regulated market will also provide an incentive for non-compliance or there will be an increasing risk that management will make determination that rules do not apply and will bypass board review of potentially abusive transactions. To sum it up, regulation of related party transactions should attempt to balance the conflict of interest concerns with the negative impact that this regulation could have on the marketplace.

APPENDIX 1: Definition of related party

United States of America

FASB Statement No. 57 defines related parties as the following:

- 1) Affiliates of the enterprise. An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise. Control for purpose of FASB Statement No. 57 means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.
- 2) Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- 3) Principal owners of the enterprise. Principal owners are owners of record or known beneficial owners of more than 10% of the voting interests of the enterprise.
- 4) Management of the enterprise. Management includes persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.
- 5) Members of the immediate families of principal owners of the enterprise and its management. Immediate family includes family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
- 6) Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- 7) Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

NYSE Listed Company Manual Section 307.00 defines 'related party' as:

- directors
- subsidiaries, associates, affiliates
- major shareholders

- close family members of directors, top management team

United Kingdom

FRS 8 defines a related party as follows:

"Two or more parties are related parties when at any time during the financial year:

- a) one party has direct or indirect control of the other party;
- b) the parties are subject to common control from the same source;
- c) one party has influence over the financial and operating policies of the other party to the extent that the other party might be inhibited from pursuing at all times its own separate interests;
- d) the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests."

Other categories are assumed to be related unless the contrary can clearly be demonstrated. These categories are:

- 1) The key management of the reporting entity and the key management of its parent. Key management is defined in the FRS 8 as 'Those persons in senior positions having authority or responsibility for directing or controlling the major activities and resources of the reporting entity'.
- 2) Major shareholders, being persons able to exercise control over 20% or more of the voting rights of the reporting entity.
- 3) Persons acting in such a way as to be able to, through a formal or informal agreement or understanding, exercise control or influence over the reporting entity.
- 4) An entity managing or managed by the reporting entity under a management contract.

Finally, because of their relationship with certain parties that are related parties of the reporting entity, the categories that appear below are also presumed to be related parties of the reporting entity:

- 1) Members of the close family of any individual falling under parties mentioned in (1) – (3) above. Close family is defined in the FRS 8 as 'Those family members, or members of the same household, who may be expected to influence or be influenced by that person in their dealings with the reporting entity'.
- 2) Partnerships, companies, trusts or other entities in which any individual or member of the close family in (1) – (3) above has a controlling interest.

The UK Listing Authority Listing Manual defines related party as:

- (i) a substantial shareholder;
- (ii) any person who is (or was within the 12 months preceding the date of the transaction) a director or shadow director of the company or of any other company which is (and, if he has ceased to be such, was while he was a director or shadow director of such other company) its subsidiary undertaking or parent undertaking or a fellow subsidiary undertaking of its parent undertaking; or
- (iii) an associate of a related party within (i) or (ii) above;

Australia

AASB 1017, “Related Party” means, in relation to an entity:

- a) any other entity that has control or significant influence over the entity; or
- b) any other entity that is subject to control or significant influence by the entity; or
- c) any other entity that is controlled by the same entity that controls the entity - referred to as a situation in which entities are subject to common control; or
- d) any other entity that is controlled by the same entity that significantly influences the entity; or
- e) any other entity that is significantly influenced by the same entity that controls the entity; or
- f) any director or specified executive of the entity or any of their personally-related entities; or
- g) any director of any other entity identified as a related party under any of paragraphs (a) to (e), or any of their director-related entities;

but excludes any other entity [except those identified as a related party under paragraph (f)] where the related party relationship results solely from normal dealings of: financial institutions; or trade unions; or statutory authorities; or government departments; or local governments

Section 229 of the Corporations Law defines related party as:

- giving financial benefits indirectly, through one or more group entities
- giving a financial benefit by making an informal agreement, oral agreement or non-binding agreement
- giving a financial benefit that does not involve paying money

The Australia Stock Exchange, ASX Listing Manual Chapter 10 “Related party” refers to:

1. directors of the company
2. directors (if any) of an entity that controls the company
3. spouses of the persons referred to in paragraphs (1) and (2)

The following relatives of persons referred to in (1), (2) and (3) are related parties of the public company: parents; children.

4. an entity controlled by a related party referred to in subsection (1), (2) or (3)

Hong Kong

HKSA Statement 2.120 deals only with the “related party” described below:

- 1) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
- 2) joint ventures and associated companies of the reporting enterprise and enterprises that, directly or indirectly, have significant influence over or are under common significant influence with the reporting enterprise;
- 3) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and close members of the family of any such individual (close members of the family of an individual are those that may be expected to influence, or be influenced by, that person in their dealings with the enterprise);
- 4) key management personnel of the reporting enterprise and its holding companies and close members of the family of such individuals. Key management personnel are those persons that have authority and responsibility for planning, directing and controlling the activities of an enterprise (in the case of a company, this would include directors and officers);
- 5) enterprises over which any person described in (3) or (4) is able to exercise control or significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

The Stock Exchange of Hong Kong Limited Listing Rules Chapter 14, “connected person” include:

- a) any person or company with whom a director, chief executive or substantial shareholder of the issuer or any of its subsidiaries has entered, or proposes to enter, into an agreement, arrangement, understanding or undertaking, whether formal or informal and whether express or implied; and
- b) any person cohabiting with a director, chief executive or substantial shareholder of the issuer or any of its subsidiaries as a spouse or any relative of a director, chief executive or substantial shareholder of the issuer or any of its subsidiaries, including:
 - a child or step-child of the age of 18 or over;
 - a parent or step-parent;
 - a brother, sister, step-brother or step-sister; or
 - a mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law or sister-in-law, and
- c) any such person deemed to be an associate

Singapore

“Related party”, as defined in SAS 21 includes the following:

- 1) holding company, subsidiaries, sub-subsidiaries and associated companies
- 2) individuals having significant influence over the reporting corporation
- 3) close family members (eg: parents, child) of key management personnel of the reporting enterprise and enterprises owned by the same individuals or managed by same key management personnel

SAS 21 excludes the following from its definition of “related party”:

- two companies simply because they have a director in common
- provider of finance
- trade union
- public utilities
- government departments and agencies
- a single customer, supplier, franchiser, distributor or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

Singapore Exchange (SGX) Listing Manual Chapter 9A, "interested person" means:

- a) a director, chief executive officer, or controlling shareholder of the issuer; or
- b) an associate of any such director, chief executive officer, or controlling shareholder.

APPENDIX 2: Summary of RPT disclosure in financial documents

	USA	UK	Australia	Hong Kong	Singapore
(A) Type of RPT to be disclosed:					
Conducted on an arm-length basis (normal terms)	√	√	√	√	√
Not conducted on an arm-length basis	√	√	√	√	√
Transfers where no prices are charged	√				
(B) Details of disclosure of RPT:					
Identity of RP	√	√	√	√	√
Nature of relationships	√	√	√	√	√
Nature of the transactions		√	√	√	√
The extent of the transactions		√			
Description of the transactions (including pricing policy)	√	√	√	√	√
Dollar amount of the transactions	√	√	√	√	√
How terms differ from arm's length terms					
Bases of determining terms (including any changes)	√				√
Balances due to or from RP and the terms of settlement	√	√			

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