

RELATED PARTY FINANCIAL STATEMENT DISCLOSURES- PURPOSES, SUBJECT AND NUMBER FOR HONG KONG H-SHARES

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INTRODUCTION

International financial markets are rapidly becoming a single global market. For these markets, most large institutional users are not satisfied with the existing levels of disclosures by multinational firms (Taylor, 1995). This study will examine one type, related party disclosures, for H-Shares in Hong Kong. In Hong Kong, different groups are concerned about disclosure issues. Cha, Securities and Futures Commission (SFC) executive director, has stated it was important to adopt international standards as part of the SFC and stock exchange's commitment to maintaining Hong Kong's competitiveness (Ibison, 1995). Also, a committee of the Hong Kong Society of Accountants has announced a proposal that was submitted to the society's council in 1996 that included changes in corporate governance disclosure practices for implementation.

The shares for the first H-share company, Tsingtao Brewery, were sold in 1993. Chinese companies are allowed to sell their shares to foreign investors on the Hong Kong Stock Exchange (HKSE) and these shares are called H-shares. Today over thirty Chinese companies sell their shares in Hong Kong. Two other types (A and B shares) may be owned only by Chinese citizens or foreign investors respectively. These shares are traded on either the Shanghai Securities Exchange or Shenzhen Stock Exchange in China that were opened only in 1990 and 1991 respectively.

Very little detailed information is known about the accounting practices for H-shares. The lack of transparency for the H-shares has been cited as a factor behind the poor performance that saw counters touch new lows in the second half of 1995 (Leung, 1996). China has been criticized for having the worst disclosure regulation. The number of China related companies including both H-shares and so called red chip companies (Chinese mainland companies doing most of their business in the mainland, but headquartered in Hong Kong) listed in Hong Kong has grown from five in 1990 to 97 in 1997. The percentage of China related companies in Hong Kong has, also, increased from 2% in 1990 to 15% in 1997. Funds raised by China-related companies represented 83% of the total funds raised in 1997 (Ward, 1997). In 1996, the head of Coopers & Lybrand's China Audit Technical Group, stated, "It's not a problem of standards - it's a problem of practice" (SCMP, 1996). However, Hong Kong has been rated as having the best shareholder communications regime in Asia (Fung, 1997).

An exposure draft, "Related Party Disclosures" was issued by the Hong Kong Society of Accountants (HKSA) in February 1996. The HKSA finalized the statement, Statement of Standard Accounting Practice No. 20, "Related Party Disclosures", in late 1997 with the standard applying to accounting periods beginning on or after October 1997. The statement is based on International

Accounting Standard No. 24, "Related Party Disclosures" that mandates the disclosure of all material related party transactions, whether or not made at arm's length, and disclosure of related party relationships where control exists. There are some differences, for example, as SSAP No. 20 does not require (required by IAS 24) the disclosure of related party relationships where control exists, irrespective of whether or not there have been transactions between related parties.

According to the Serious Fraud Office in the United Kingdom, one of the main reasons auditors fail to find fraud is the auditor's failure to identify related party transactions (Knox, 1994). Also, the inadequate disclosure of related party transactions is the most frequently used and most successful type of fraud. Related party transactions include conflict of interest and sham transactions. Companies can inflate sales and profits by selling to a company owned by an unrelated co-conspirator. Sham transactions can be used to hide the true nature of a transaction (Kerwin, 1995).

In the next section, the purpose of this study is discussed.

PURPOSE

The purpose of this research study was to investigate existing related party footnote disclosure practices for financial statements for H-shares and determine if the practices are similar for H-shares and other companies traded on the Hong Kong Stock Exchange. In addition, this project attempts to determine if existing related party disclosures for H-share companies can be classified according to the purposes identified in the US study and by a review of Hong Kong annual reports.

Part of the objective was descriptive. The study summarized and analyzed the related party footnote disclosures for a sample of Hong Kong H-share companies. In a recent study, Barth and Murphy (1994) developed a framework to analyze the required footnotes for companies in the United States. This study uses a similar approach to examine the situation in Hong Kong for this one type of disclosure. However, there are some significant differences. The Barth and Murphy study is extended to include the review of actual disclosures in financial statements. Descriptive statistics are included in the study. Statistical tests are used to determine if practices for related parties are similar.

METHODOLOGY

Information about the accounting disclosures for related parties for H-shares was gathered from 1996 annual reports. This date was before the implementation date for the new standard so the new rules were not required at that time. Twenty-seven companies were selected for the study (see Table 1 for complete company list).

(Table 1 About Here)

The twenty-seven companies represent all of the H-share companies traded on the Hong Kong Stock Exchange in 1996. Annual reports were not available for the other thirteen companies because the companies were not traded until after 1996. All companies had 31 December 1996 year-ends.

Data had to be hand collected in all cases. This lack of available information makes any analysis more difficult and inefficient. In the future, the development of a more complete database would be useful for research.

RESEARCH QUESTIONS

Several research issues were examined during this study. In the first section, descriptive statistics will be provided. In the second, tests to determine if the disclosure level for related parties for H-shares are different for other Hong Kong companies is conducted. As discussed, the disclosure levels for these H-shares have been criticized. If the accounting practices are similar for H-shares and other shares traded on the HKSE, then the specific disclosures for related parties would be expected to be similar. This study investigates the existing disclosures to determine if the levels are, in fact, similar.

The hypothesis to be tested follows:

H1: The disclosure levels for related parties are the same for H-shares as compared to other companies traded on the HKSE.

A Z-test will be conducted to determine if H1 can be rejected statistically.

RESULTS

I. Number of Companies with Related Parties Disclosures

All twenty-seven H-share companies included a footnote disclosing related party information. Sixty-five related parties (average 2.41 parties per company) were identified in the twenty-seven annual reports.

One company described an agreement in a related party footnote as follows:

RELATED PARTY TRANSACTIONS

Every non-executive directors has confirmed that the above-mentioned transactions have been entered into in the ordinary and usual course of business of the Group and on normal commercial terms or on terms no less favourable than terms available to/from independent third parties and are fair and reasonable so far as the shareholders of the Company are concerned.

- (a) By an agreement dated 14 July 1993, BGC agreed to be the sole sales agent for the Company's products in the PRC at a fee equal to three percent of the domestic sales in the PRC of the Company's products.

By an agreement dated 14 July 1993, Beijing Yan Long Import & Export Company, a subsidiary of BGC, agreed to provide to the Company export sales, marketing and after sales

services for the Company's products at a fee equal to three percent of the annual export turnover of products marketed by Beijing Yan Long Import & Export Company.

- (b) By an agreement dated 18 June 1994, BGC agreed to grant to the Company the right to use the factory area, roads and relevant facilities for a term of 50 years at a fee of Rmb2,000,000 per annum with the term calculated from 1 January 1993. BGC also agreed to deduct this fee from the sole agent fee as note (21) (a) mentioned. If the annual sole agent fee receivable by BGC is less than Rmb2,000,000, BGC agreed to refund the amount equals to the excess of Rmb2,000,000 over the sole agent fee to the Company.
7. By an agreement dated 14 July 1993, BGC agreed to grant to the Company the right to use the "Beiren" trademark for its products at a fee payable quarterly of Rmb15,000 or at the rate of one percent of the sale proceeds from products using the "Beiren" trademark during that relevant period, whichever is the higher. (Beijing Datang Power Generation Co., 1996)

Another company disclosed the following footnote:

RELATED PARTY TRANSACTIONS

Business transactions between the Company and the SHS Group, the Company's fellow subsidiaries and related companies for the year ended 31 December 1996 are as set out below.

- (1) Pursuant to a Services Agreement dated 4 July 1994, between the Company and the SHS Group, the SHS Group undertook to provide various services to the Company, relating to, amongst other things, the provision of bunker oil, fuel and material supplies, the supply of fresh water, the installation and maintenance of telecommunication and navigational devices, ship repairs and maintenance, the provision of medical supplies, accommodation for employees and educational training for navigation officers, engineers, technicians, marine officers and electricians. In the same agreement, the Company undertook to provide general control office services relating to the administration and management of vessels. The Services Agreement was effective from 3 May 1994 for a term of ten years, unless terminated earlier by either party upon the giving of sixty days notice. (Shanghai Hai Xing Shipping Co., 1996)

A third company included the following;

RELATED PARTY TRANSACTIONS

A significant portion of the transactions undertaken by the Group during the year has been effected with other PRC State-owned enterprises and on terms determined by the Group and the relevant PRC authorities.

The following is a summary of the significant transactions carried out in the normal course of business between the Group and its related companies during the year:

	1996	1995
	RMB'000	RMB'000
Fellow subsidiaries Sales of finished goods and raw materials	66,287	30,235
Associated companies Sales of finished goods and raw materials	5,923	5,980
Purchases of raw materials	7,484	9,004
Related company Sales of finished goods and raw materials	-	1,432

In the opinion of the directors, the transactions stated above were carried out in the ordinary course of business on normal commercial terms and on terms no less favourable than terms available to third parties. (Chengdu Telecommunication Cable Co., 1996)

An additional firm disclosed the following:

RELATED PARTY TRANSACTIONS

Material related party transactions for the period from 15th August 1996 to 31st December, 1996, other than disclosed in Notes 13 and 16, are summarized as follows:

- (a) Toll revenue collections for the period from 15th August, 1996 to 31st December, 1996 were deposited into bank accounts of AEHC which held the funds in trust for the Company. This arrangement resulted in an amount due from AEHC of approximately RMB69 million as of 31st December, 1996. This balance earns interest at 9.18% per annum and has been repaid by AEHC subsequent to 31st December, 1996.

Subsequent to 31st December, 1996, revenue collections have been deposited into the Company's own bank accounts.

- (b) The Company entered into an agreement with AEHC to lease certain premises for use as its head office. The property was rented to the Company for a term of three years, from 23rd August, 1996 to 22nd August, 1999. The annual rental is RMB99,360 for the first two years. The rent is subject to a 5% increase from the third year onwards. During the period from 15th August, 1996 to 31st December, 1996, the rental payable to AEHC amounted to RMB33,750. (Anhui Expressway Co., 1996)

In the next section, the results for statistical tests are presented.

I. Results for Hypothesis Testing

Twenty-seven H-share companies had at least one related party disclosed in their 1996 annual reports. In a recent study (Miller, 1997), only six percent (6/ 100) of the selected Hong Kong companies had at least one related party disclosed in their respective 1996 annual reports. The data from this study and the 1997 study were used to conduct a test of proportions to determine if the null hypothesis can be rejected. The null is that $p_1 = p_2$. The hypothesis stated in a different form is repeated as follows:

H1: The level of disclosures for H-shares for related parties is the same as the level of disclosures for other Hong Kong shares.

The alternative hypothesis can be stated as $p_1 > p_2$. P_1 is defined as the proportion, number of h-share companies with a related party for 1996 divided by the total number of h-share companies (27/ 27). P_2 is the number of other HK companies with related parties for 1996 from the 1997 Miller study divided by the total number of other HK companies (6/ 100). The companies selected for the two studies are considered stratified independent samples for all companies traded on the HKSE in 1996. The test of proportions yields a z-value of -20.81. At a 5% confidence level, the critical z is -1.645. The null hypothesis can be rejected.

These results provide evidence that the disclosure levels for related parties for H-shares are significantly higher than the levels for the other HK shares. Because of the small sample sizes, any conclusions need to be carefully considered. Further research needs to be conducted to confirm the possible reasons for the disclosure level differences. Most H-share companies have a relationship with the PRC government that must be disclosed as a related party. This is the probable reason that all H-share companies had, at least, one related party disclosure in this study.

In the next section, the results are summarised and discussed.

SUMMARY AND DISCUSSION

Additional accounting guidance for related party transactions may not need to be provided by the HKSA for H-shares in Hong Kong. All companies provided related party disclosures in 1996. The level of detail does vary greatly for these companies. Many firms included extensive details about activities with related parties.

The actual disclosures in this study appear to meet several purposes. Barth and Murphy determined that related party disclosures met the following general purposes, 1) describe recognised items and provide relevant measures of those items other than the measure in the financial statements, and 2) provide information to help investors and creditors assess risks and potentials of both recognised and unrecognised. The Hong Kong H-share footnotes do appear to meet these same general objectives. However, the level of detail varies greatly. Probably more importantly, the major difficulty is the lack of consistency. Related party disclosures do appear to be adequate.

China has addressed the related party issues. A new standard, "Accounting Standard for Business Enterprises: Disclosure of Related Party Relationships and Transactions" has been issued that is effective for listed Chinese companies from 1 January 1997. This standard is, also, based on IAS No. 24, but there are significant differences. For example, transactions between state-controlled enterprises are disclosable when the transacting enterprises are regarded as related parties. Also, the standard provides a specific definition that an individual investor who controls, directly or indirectly, 10% or more of the voting capital of an enterprise is a related party. IAS No. 24 does not give a specific percentage, but states if there is significant influence then there is a related party transaction.

The Hong Kong Society of Accountants may need to evaluate the accounting disclosures in the related party area. The H-shares and other Hong Kong may be applying a somewhat different standard. At this time, comparisons among Hong Kong companies may be difficult. Different disclosure methods are, apparently, being used by companies. The new standard should increase the comparability among H-shares and other companies traded on the HKSE by standardising the required disclosures. Research in the future should be conducted to confirm that the level of disclosures becomes similar for both groups. Consistent disclosure practices may be critical in the future. It is hoped that this study has provided some useful information about the status of corporate financial reporting for related party transactions.

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Table 1: Companies of H - shares			
No	Industry Sector Code	Stock Code	Company Name
1	I	995	Anhui Expressway Co Ltd
2	U	991	Beijing Datang Power Generation Co Ltd
3	I	187	Beiren Printing Machinery Holdings Ltd
4	I	1202	Chengdu Telecommunication Cable Co Ltd
5	C	670	China Eastern Airlines Corporation Ltd
6	I	1072	Dongfang Electrical Machinery Co Ltd
7	I	921	Guangdong Kelon Electrical Holdings Co Ltd
8	U	525	Guangshen Railway Co Ltd
9	I	317	Guangzhou Shipyard International Co Ltd
10	I	1133	Harbin Power Equipment Co Ltd
11	I	368	Jilin Chemical Industrial Co Ltd
12	I	350	Jingwei Textile Machinery Co Ltd
13	I	300	Kunming Machine Tool Co Ltd
14	I	1108	Luoyang Glass co Ltd
15	I	323	Maanshan Iron and Steel Co Ltd
16	I	553	Nanjing Panda Electronics Co Ltd
17	M	1138	Shanghai Hai Xing Shipping Co Ltd
18	I	338	Shanghai Petrochemical Co Ltd
19	I	1065	Tianjin Bohai Chemical Industry (Group) Co Ltd
20	I	168	Tsingtao Brewery Co Ltd
21	I	1033	Yizheng Chemical Fibre Co Ltd
22	I	576	Zhejiang Expressway Co Ltd
23	I	1128	Zhenhai Refining and Chemical Co Ltd
24	I	1122	Qingling Motors Co Ltd
25	I	42	Northeast Electrical Transmission and Transformation Machinery Manufacturing Co Ltd
26	I	719	Shandong Xinhua Pharmaceutical Co Ltd
27	I	548	Shenzhen Expressway Co Ltd

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