

NOTES OF CASES

IMPLICATIONS OF THE TARLING CASE ON THE ACCOUNTING STANDARD FOR THE REPORTING OF RELATED PARTY TRANSACTIONS UNDER THE COMPANIES ACT¹

*P.P. v. Tarling*²

Introduction

THE decision in the *Tarling* case has aroused the interest of auditors, directors and their legal advisers in view of the true and fair view requirements of the Companies Act in relation to related party transactions. Such transactions are, in recent years, becoming a matter of increasing concern, having caused many corporate scandals in USA, UK, Canada and Australia. This concern has prompted accountancy bodies in many countries to promulgate professional standards requiring the disclosure of related party transactions in financial statements. One such standard is International Accounting Standard No. 24 (IAS 24) issued by the International Accounting Standards Committee in July 1984. This accounting standard was approved by the Council of the Singapore Society of Accountants for issuance as a Provisional Statement of Accounting Standard in February 1985. This article seeks to review the reporting requirements of related party transactions under IAS 24 and to assess whether they meet the provision of a true and fair view under the Companies Act as laid down in the *Tarling* case.

Meaning of Related Parties

Under IAS 24 two parties are considered to be related if one party has the ability to *control* the other party *or* exercise *significant influence* over the other party in making financial and operating decisions. It can be seen from the definition that the meaning of 'related parties' is wider than the statutory definition of 'related corporation' under the Companies Act.³ The term 'related parties' under IAS 24 includes not only related companies but also associated companies, non-controlling substantial shareholders, directors and other policy-making members of management and other forms of relationships in which the key factor of *control* or *significant influence* is present.

¹ Cap. 185 (Reprinted).

² *P.P. v. Tarling*, (1979), Unreported, High Court; [1981] 1 M.L.J. 173, Court of Appeal.

³ Under section 4 of the Companies Act, 'related corporation' in relation to a corporation, means a corporation that is deemed to be related to the first-mentioned corporation by virtue of section 6. Section 6 sets out when corporations are deemed to be related to each other: "Where a corporation— (a) is the holding company of another corporation; (b) is a subsidiary of another corporation; or (c) is a subsidiary of the holding company of another corporation, that first-mentioned corporation and that other corporation shall for the purposes of the Act be deemed to be related to each other."

True and Fair View

Sections 199 and 201⁴ of the Companies Act require that the balance-sheet and profit and loss account of a company shall give a true and fair view of the company's financial position at the end of the financial year. There is however no statutory or judicial definition of the words 'true and fair'.

The courts have never attempted to define 'true and fair' in the sense of offering a paraphrase in other languages and in our opinion have been wise not to do so. When a concept can be expressed in ordinary English words, we do not think it illumines their meaning to attempt to frame a definition... It is much more useful to illustrate the concept in action, for example, to explain why certain accounts do or do not give a 'true and fair view'.⁵

Johnston, Jager and Taylor express three ways of interpreting this phrase:

- (a) literally, and in their ordinary or popular meaning, that is, without regard to possible technical interpretations,
- (b) technically, in accordance with accounting standards promulgated by the leading accountancy bodies or followed in best practice, or
- (c) technically, in accordance with accepted accounting or business practice which may in the extreme mean that 'somebody has tried it'.⁶

It seems that most accountants in practice apply the technical meaning in (b) above and this appears to have received support from official pronouncements of accountancy bodies. Lawyers, however, favour a wider interpretation of the words in their popular sense. Despite differences of approach, there is a broad consensus on the effect of compliance with authoritative Statements of Accounting Standards in respect of all financial statements which are intended to show a true and fair view of a company's financial position. Both lawyers and accountants are in agreement that financial statements drawn up in accordance with accepted accounting standards provide *prima facie* evidence that the accounts are true and fair, and that the reverse is *prima facie* evidence that the accounts may not show a true and fair view.⁷ While the courts will almost certainly treat such compliance as evidence of a true and fair view, it is not bound by any accounting standard and may, in appropriate cases, hold otherwise. This is because at the end of the day, the courts must decide whether the accounts are true and fair under the Companies Act, not merely whether they conform with the accounting profession's promulgated standards or generally accepted practices.⁸

⁴ Previously sections 167 and 169 respectively.

⁵ Leonard Hoffmann Q.C. and Mary H. Arden: 'Legal Opinion on True and Fair' *Accountancy*, November 1983, 154. This opinion was sought by the U.K. Accounting Standards Committee.

⁶ Trevor R. Johnson, Martin O. Jager and Reginald B. Taylor, *The Law and Practice of Company Accounting*, (Fifth Ed., 1983, Butterworths, Sydney) 225.

⁷ Report of the U.K. Sandilands Committee, Report of the Inflation Accounting Committee, 1975 Cmnd. 6225, paras. 50 and 52; Policy of the Commissioner for Corporate Affairs in Australia.

⁸ For example, see *US v. Simon*, F.2d, CCH Fed. Sec. L. Rep. 92511, 2nd Cir. 1969; also *Escott v. Bar Chris Construction Corp.*, 283 F. Supp. 643, 701 (S.D.N.Y. 1968).

An Accounting Perspective of Related Party Transactions

For the purposes of preparing balance sheets and profit and loss accounts, the Companies Act does not specify the general valuation basis to be used: whether it is historical cost, current replacement cost, current realisable value or other valuation basis. Furthermore, the Companies Act does not define the terms 'state of affairs', 'results' or 'true and fair view' although it does prescribe certain specific disclosures in the balance sheets and profit and loss accounts such as those listed in the Ninth Schedule. As such it is not possible to deduce from the provisions of the Companies Act what the proper valuation basis for preparing balance sheets and profit and loss accounts should be. In practice, accountants have assumed that the historical cost method of accounting is the proper basis of measuring transactions despite the fact that that basis has come under severe criticisms from accounting academics. The historical cost method is based on the assumption that the exchange price resulting from arm's length bargaining represents fair value and that this is the appropriate value to be used in recording a transaction. Such an assumption while normally tenable in the case of arm's length transactions between independent parties poses problems in relation to related party transactions. The nature of the problem is explained in International Accounting Standards Exposure Draft 25 (the precursor of the final standard IAS 24) as follows:

Because related parties are, by definition, not independent in the pursuit of their own separate interests, there may be a degree of flexibility in the price-setting process that is not present in transactions between independent parties.... Sometimes, prices are set at amounts that do not appear to reflect the value of the resources transferred....

To overcome this problem and to achieve the accounting objective of measuring fair value, accountants should attempt to use an arm's length equivalent price whenever available, and not the exchange price, in measuring non-arm's length transactions.⁹ However, certain accountancy bodies¹⁰ maintain that the difficulty of obtaining arm's length equivalent prices is too pervasive a problem and accept that related party transactions should be measured at their exchange prices in all cases, even in cases where such equivalent prices are obtainable.

IAS 24

IAS 24 seeks to adopt a disclosure solution to the related parties problem as expressed in the following paragraphs of the pronouncement:

- 25 Related party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties.
- 26 If there have been transactions between related parties, the reporting enterprise should disclose the nature of the related party relationships as well as the types of transactions and the elements of the transactions necessary for an understanding of the financial statements.

⁹ Mason, A.K., *Related Party Transactions: A Research Study*, Canadian Institute of Chartered Accountants, Toronto, 1979.

¹⁰ The American Institute of Certified Public Accountants (in Statement of Auditing Standard No. 6), the US Financial Accounting Standards Board (in Statement of Financial Accounting Standard No. 57), and presently the International Accounting Standards Committee (in IAS No. 24).

- 27 Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

The elements referred to in paragraph 26 above are elaborated in paragraph 21.

... These elements would normally include:

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

It is to be noted that IAS 24 does not require disclosure of the arm's length equivalent price or the fact that it cannot be determined. It does, however, require pricing policies to be disclosed.

The Facts of the Tarling Case

In *P.P. v. Tarling*¹¹ the accused was charged with five offences under sections 169(6)(o), (p) and 169(14) of the Companies Act involving non-disclosure of transactions between Haw Par Brothers International Limited (HPBIL) and a related party, Grey Securities Ltd. (Grey). Grey was until its sale, a wholly-owned subsidiary of HPBIL and, after its sale, it remained under the full beneficial ownership and control of HPBIL although technically it ceased to be a subsidiary. The substance of the five charges against HPBIL were:

- (a) wilfully failing to give a true and fair view of the profits of the company under s. 169(14) for the years ended 31 December 1972 and 1973 by failing to secure that the accounts disclosed profits made by Grey, its sale to Legis (a nominee of HPBIL) and the effect thereof;
- (b) wilfully failing to state in the directors' report for the years ended 31 December 1972 and 1973 under s. 169(6)(o) appropriate details of circumstances not otherwise dealt with in the directors' report or accounts, namely, to give particulars of, *inter alia*, the sale of Grey, the creation of the Melbourne Unit Trust (MUT), and the profits of Grey, thereby rendering the accounts misleading;
- (c) wilfully failing to state with appropriate details as required by s. 169(6)(p) in the directors' report that the companies' operations during the financial year 1972 were, in the opinion of the directors, substantially affected by a transaction of material and unusual nature namely, the sale of Grey at a cost valuation despite very substantial profits realized by Grey before the sale.

Tarling was found guilty by the High Court and sentenced to six months imprisonment. The decision was affirmed on appeal.¹²

The analysis in this article will be confined to the financial year 1972. The events leading to these charges are as follows:

¹¹ (1979), Unreported. This case is also discussed in Myint Soe: *The Director and the Law*, [1982] 2 M.L.J. ix.

¹² [1981] 1 M.L.J. 173.

In June 1971 Slater Walker Securities Ltd. (UK) acquired a controlling interest in HPBIL, whereupon Tarling became one of the directors, and subsequently Chairman in September 1971. In February and March 1972, HPBIL's subsidiary, Haw Par Brothers Hong Kong Ltd. (HPBHK) obtained shares in two Hong Kong public companies. (1) 7 million shares at HK\$1.20 per share in Kwan Loong & Co. (KL) and (2) 6.6 million shares at HK\$2.85 per share in King Fung Development Ltd. (KF). The value of these shares rose and from March 1972 HPBHK sold these KL & KF shares making phenomenal profits.

The profit and loss account of HPBHK for the period January to 28 June 1972 showed a retained profit of HK\$25.5 million, after paying a dividend of HK\$7 million out of realised pre-tax profits of HK\$35.4 million. The HPBIL management then decided to devise a scheme to avoid consolidating the profits of HPBHK (now renamed Grey) with the rest of the HPBIL group's profits. The aim was to stack away Grey's exceptional profits as a hidden reserve so that it could be used in future years to show a pattern of steady growth. This would secure a growing confidence in the new management which in turn would be reflected by a high market rating of HPBIL shares.

The scheme involved the setting up of a private unit trust called MUT on June 27, 1972 with all units effectively owned by HPBIL through nominees. On June 28, 1972 HPBIL sold Grey to MUT for a book value of HK\$10.8 million (the original cost to HPBIL) even though its 'worth' on that date was HK\$60.3 million based on the market value of its underlying net assets. The HK\$60.3 million comprised Grey's paid up capital of HK\$10.8 million plus realised profits retained of HK\$25.5 million and unrealised profits of HK\$24 million. By means of this scheme HPBIL avoided consolidating the realised profits of Grey since Grey had now gone under the trust and was no longer a subsidiary whose accounts were required to be consolidated with the group accounts. As a result, HPBIL's consolidated profits for the year ended 31 December 1972 were grossly understated. Instead of being consolidated with the rest of the HPBIL group, the MUT (and therefore its underlying investments such as Grey) was included under 'other investments' in HPBIL's company balance sheet and similarly included in HPBIL's consolidated balance sheet. Likewise, there was no separate disclosure of the formation of MUT or the sale of Grey to the MUT in either the parent company or the consolidated financial statements of HPBIL.

The Judgement

The relevant aspects of the judgment of the High Court, affirmed by the Court of Appeal, may be conveniently dealt with as follows:

Consolidation of MUT Account in HPBIL Consolidated Accounts

The High Court held that the consolidated accounts of HPBIL and its subsidiaries should have included for the year ended 31 December 1972 the phenomenal profits made by Grey. As a result of this exclusion, the financial statements of the group did not give a true and fair view. The best way to do so was to ignore the artificial device of the unit trust and to voluntarily consolidate Grey in the HPBIL consolidated accounts, even after it had ceased to be a subsidiary. This was because Grey was still, in substance though not in

form, a subsidiary of HPBIL and the 'trust effects of the group' should be recognised in the consolidated statements.¹³ The High Court stressed that:

The MUT scheme was an entirely novel idea and there were certainly no accounting standards to meet this situation. In these circumstances, it is no good saying we have not infringed any accounting standards. The accountants and the directors here, including the accused, should have seen to it that the consolidated profit and loss account showed a true and fair view of the profits of the group during the year 1972¹⁴

Disclosure by Means of Notes to the Accounts

As an alternative to consolidation, the Court held that there should have been a clear note to the accounts or a statement in the directors' report reflecting the actual worth of the units in MUT at the time of investment as they were worth much more than was disclosed.

... There should have been a note referring to the formation of MUT and showing that the underlying asset was Grey with HK\$35.4 million as realised profits and HK\$24 million as unrealised profits thereby showing the worth of that investment on June 28, 1972. The note should also cover the fact that Grey prior to its going under the trust was a wholly owned subsidiary of HPBIL. This will bring home to the shareholders that the realised profits of Grey were those of the HPBIL group until it was sold to MUT. The shareholders, the investing public, and others interested in HPBIL were nowhere told about these very large profits made by Grey and therefore by the HPBIL group. There was not even a hint about this anywhere at all.... As all this was not done in the notes to the consolidated accounts of HPBIL the directors' report should have covered these matters.¹⁵

In short, the High Court in effect required the *disclosure* of the market value of Grey at the time of sale and did not seem to require the *remeasurement* of the sale at market value.

Implications of the Tarling Case on IAS 24

In the light of the decision in the *Tarling* case it would appear that IAS 24 has failed in certain aspects to meet the requirements of a true and fair view under the Companies Act in relation to the reporting of related party transactions. The implications of the *Tarling* case on IAS 24 are dealt with under the following heads:

(a) *Consolidation*

Given the doubts as to whether the application of IAS 24 would lead to the consolidation of Grey in the accounts of HPBIL as required by the *Tarling* case, it is necessary to take into account other present day accounting standards relevant to the situation, but not promulgated at the time of the events leading to the trial. Therefore, besides IAS 24 on related party transactions, IAS 3 on Consolidated Financial Statements and IAS 1 on Disclosure of Accounting Policies should also be applied.

¹³ *P.P. v. Tarling* [1981] 1 M.L.J. 173.

¹⁴ *P.P. v. Tarling* (1979) Unreported, *per* Kulasekaran J.

¹⁵ *Ibid.*

There is no assurance that the application of IAS 24 will lead to the consolidation of Grey in the accounts of HPBIL since the standard focusses on *disclosure* without first insisting on a proper recognition of the substance of a related party transaction in the initial recording of the transaction. The application of IAS 3 will also not result in the consolidation of Grey since IAS 3 does not deal with joint ventures, partnerships or other unincorporated entities such as the MUT under which umbrella Grey was hidden. Although IAS 1 on Disclosure of Accounting Policies states that 'prudence, *substance over form*, and materiality should govern the selection and application of accounting policies', this general provision applies only in the absence of specific provisions on individual topics such as related party disclosure which is covered by IAS 24.

(b) *Disclosure in Lieu of Consolidation*

In this aspect the application of IAS 24 shows that the standard only partially meets the disclosure requirements laid down in the *Tarling* case. Matters of which IAS 24 requires disclosure are the sale of Grey, the related party relationship involved, the actual sale price of HK\$10.8 million and the basis by which this price was determined (i.e. the fact that it was based on the original cost to HPBIL). But IAS 24 departs from the legal requirement that the 'worth' of Grey at the time of sale must be disclosed. The term 'worth' refers to the summation of Grey's paid up capital of HK\$10.8 million, realised profits of HK\$25.5 million and unrealised profits of HK\$24 million (totalling HK\$60.3 million). 'Worth' therefore means the net tangible assets (NTA) at market value (i.e. computed by valuing Grey's underlying securities at their prevailing share market quotations). The amount of the NTA is important as it may be regarded as a surrogate of Grey's arm's length equivalent price. This will be discussed below.

(c) *Recording (Accounting Measurement) of Related Party Transactions at Exchange Price*

The application of the accounting measurements provisions of IAS 24 demonstrates that, at least in respect of the initial recording of related party transactions, the standard is consistent with the legal requirement that in the HPBIL company accounts, the exchange price may be used as the basis of measuring related party transactions without the necessity of re-measuring at an arm's length equivalent price.

However under a 'fair value' basis of recording in accounting theory, an arm's length equivalent price should be used whenever this price differs from the actual solution to the related parties problem. This is the ideal accounting solution. The judicial disclosure solution (that the market value of Grey be disclosed while using its exchange value for recording the sale) is therefore a compromise solution under an accounting theory yardstick. Notwithstanding this, as discussed above IAS 24 has fallen short of the judicial compromise solution.

The use of an arm's length equivalent price in measurement (the ideal solution) is not an attempt to measure what might have happened had the parties been dealing at arm's length but rather it is an attempt to measure what has actually happened. The function of accounting

in this, context is to measure the impact of a completed transaction on the entity's economic resources.¹⁶ Whenever the exchange price differs from the arm's length equivalent price, the exchange price does not measure the real impact of that transaction on the entity's resources. It may therefore be suggested that Grey's arm's length equivalent price that should have been recorded was the price at which it could be sold as an investment company, which is not necessarily the same as what its underlying assets could be sold for. In view of the ready convertibility of its securities into cash (given the active share market conditions at the time), net tangible assets at market value could be viewed as the best available surrogate of the arm's length price for Grey. If the ideal solution were to be adopted, the financial statements in the *Tarling* case could therefore have disclosed that the arm's length equivalent price of Grey had been approximated by taking its net tangible assets using prevailing market quotations for valuing Grey's underlying securities and could have given details of the sources and types of quotations used.

Conclusion

The decision in the *Tarling* case seems to indicate that International Accounting Standard No. 24 on Related Party Disclosures would not provide sufficient guidance for the financial reporting of related party transactions to meet the statutory requirements of true and fair view under the Companies Act.

Member countries of the International Accounting Standards Committee, such as Singapore, should consider whether IAS 24 (or any other accounting standard for the matter) meets the statutory requirements before adopting it as their national standard. They should modify the provisions of IAS 24 for example by requiring the disclosure of arm's length equivalent prices where available or the fact that such equivalents are not available, as the case may be. In the latter case, the basis of determining the exchange price should also be disclosed.

In adopting any international accounting standard as the national standard it may be worth recapitulating the following:

- (a) that the words 'true and fair' have never been defined either by the courts or legislature and that the test is not an absolute but flexible one;
- (b) that the legal interpretation of 'true and fair' is wider than the accounting definition; and
- (c) the Companies Act gives limited guidance to the accounting profession in interpreting the phrase 'true and fair' beyond a statement of certain items to be disclosed, terminology and classification.

These considerations must have been present in Ryan's mind when he came to the conclusion that

... in selecting the phrase 'true and fair view' as the standard by which the profit or loss of a company and the state of its affairs are to be judged the Legislature in effect conferred a legislative function on the accountancy profession. It is a legislative function

¹⁶ Mason, A.K., *Related Party Transactions: A Research Study*, Canadian Institute of Chartered Accountants, Toronto, 1979, 116.

of an ambulatory nature: what is 'true and fair' at any particular point of time will correspond with what professional accountants as a body conceive to be proper accounting principles. The evolution, development and general acceptance of those principles will cause the concept of true and fair to shift accordingly.¹⁷

It is left to the accounting profession to take heed of the above implications and to determine the standard of reporting related party transactions in such manner as will avoid the pitfalls of the *Tarling* case. Common sense seems to be the best guide in this area.

TER KAH LENG*

SEBASTIAN CHONG **

¹⁷ F.J.O. Ryan, "True and Fair View Revisited" the Australian Accountant, February 1974, 15.

* Lecturer in Law, School of Accountancy, National University of Singapore.

** Senior Lecturer, School of Accountancy, National University of Singapore.