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Tracking The Numbers: 'Related-Party' Deals Abound at Companies

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By Gene Colter

In big business, blood is often thicker than the ink used to print the proxy statement. For proof, let's follow some folks as they go about their holiday shopping: At electronics retailer Best Buy Co., customers in the Minneapolis-St. Paul area might be strolling through two stores owned by Chairman and founder Richard M. Schulze, who leases those stores to his company. Over at Gap Inc., people may be picking out new duds at a store kitted out by Fisher Development, which happens to be owned by the brother of Gap Chairman Robert J. Fisher. These are examples of "related-party transactions" involving companies and outside firms or people with ties to someone within the companies. Most are perfectly legal and disclosed in proxy statements mailed to shareholders.

And there are hundreds of them throughout corporate America: A study to be released today by independent research firm RateFinancials Inc. shows that nearly 40% of Standard & Poor's 500 component companies have business arrangements with parties that have ties to the companies or their management. The firm, based in New York, rates financial-reporting standards at large companies, and its latest study of proxies found related-party arrangements at firms of all stripes.

Although the vast majority of related-party transactions are kosher, the practice grabbed headlines during the demise of Enron Corp., whose related-party transactions with "special-purpose entities" helped the energy company cook its books. Related-party transactions also have figured prominently in other corporate scandals.

Companies say related-party transactions are vetted by their boards and are meant to be in the best interest of shareholders, but critics contend they don't pass the smell test at a time when corporate malfeasance has damaged so many investors' portfolios.

"Related-party transactions can be avoided," says Victor Germack, president of RateFinancials.

But Donna Coallier, a partner in the transaction-services group at PricewaterhouseCoopers, counters, "You can't make a broad generalization" about related-party transactions. "There's just too much out there." Ms. Coallier gives an example of what she sees as a reasonable transaction involving real-estate investment trusts: REITs use management companies to oversee properties, and these companies often are tied to the REIT itself.

And some companies stress that related-party transactions often began back when they were just getting on their feet and have to be seen in that context. Best Buy's director of public relations, Susan Busch, says the leases on the two stores mentioned above represent great deals for the company, and that Mr. Schulze and his family took on debt "and personally purchased these stores at a time when the company could not do so."

Best Buy, based in Richfield, Minn., paid combined rent on the stores of about $950,000 for the fiscal year ended Feb. 28, 2004. The company also leases airplanes from a company owned by Mr. Schulze and a family trust. Best Buy's proxy statement says the company pays an hourly rate for the planes, and "senior management generally use the airplanes when it is more economical or practical than flying commercial airlines."

But Mr. Germack and others believe that such relations can and should be severed. “The chairman of the board doesn't have to lease his plane to the company. You can go around the block. You don't have to step in the big hole.”

Best Buy also uses an outside law firm at which Best Buy board member Elliott Kaplan is a partner. Ms. Busch says Best Buy doesn't consider Mr. Kaplan an independent director. She adds that he has worked with the company since before it went public in 1985, “and his firm has a deep understanding of our company's industry, risks and challenges and continues to work with us.” Best Buy also uses law firms other than Mr. Kaplan's.

At Gap, Fisher Development is only one of 41 contractors used by the San Francisco retailer, says spokeswoman Stacy MacLean. “Our audit and finance committees review the relationship annually," she adds. "We do take special consideration of this relationship. They're qualified.”

ANYBODY'S GUESS: Financial Accounting Standards Board rule 133 is the Rodney Dangerfield of bookkeeping regulation: It don't get no respect.

The accounting rule was put in place three years ago to shed light on hedges that contributed to the collapse of several companies. Hedges, as the name implies, hedge their holder against the prospect of some unforeseen event, such as a swoon in the dollar. FAS 133 is supposed to give investors a clearer picture of the uses and effects of the often complex financial contracts used for hedging, and it requires firms to list the value of hedges on the balance sheet at their fair or current market value.

But studies show that compliance is spotty at best: Companies are reporting hedge gains and losses in a variety of ways, complicating investors' ability to compare risk. Most companies aren't disclosing -- even in footnotes -- information on how they arrived at fair values for hedges.

“The public disclosure is very poor and, because of that, there may be a lot of risk for restatement,” says Joseph St. Denis, a former assistant chief accountant with the Securities and Exchange Commission and now a senior director for accounting research at Fitch Ratings.

A study of 57 global companies by Mr. St. Denis found wide disparities in disclosure even for commonly used interest-rate and currency hedges: Most companies made some general reference to hedge effectiveness, but few disclosed their methods for determining effectiveness.