

## Intended Manipulation of Share Prices

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### Introduction

XYZ Limited is a Limited Liability Company incorporated & domiciled in Sri Lanka under the companies Act no.07 of 2007. XYZ Limited is a fully owned subsidiary of PQR Limited. ABC Ltd is a subsidiary of the XYZ Ltd which located in same business place & governed by same directors. The principal activity of the company is providing intermediary and advisory services on financial, investments and other corporate activities and Asset Management services.

The company had an investment of Rs. 62 Million in KLM PLC shares (one of their related company incorporated in Maldives). This investment was valued at active market price of 10 Maldives Rufiyaa each. In further inquiries it was noted that the active market has been manipulated by parties within the group with the intention of recording a gain from those shares and to make the company visible as a profit making body to the interested parties of its financials.

### Discussion of the Issue

In the XYZ Ltd Financial Statements there was an Available for sale Investment in their Other Related Party Company called KLM PLC which is incorporated in Maldives. The investment balance was Rs. 62Mn approximately. During the year KLM shares reserve had been increased by Rs.49.5 Mn when compared to the prior year. This was due to the KLM share valuation as at reporting date. The company had purchased these shares at 2 Rufiyaa per share, but as at 31-12-2014 it was increased up to 10 Rufiyaa therefore XYZ Ltd has identified a capital gain of 8 Rufiyaa per share.

During the audit we noted that the client has manipulated the active market. When we obtained the share movement from Maldives Stock Exchange (MSE) share price were stable at below 5 Rufiyaa till the month of November 2014. After that there were share trades at 10 Rufiyaa per share.

	No.of Shares	%
<b>No of shares Traded below 5 Rufiyaa</b>	1,667,508	97%
<b>No of shares Traded above 5 Rufiyaa</b>	48,600	3%

	No of shares	MV MRF	Value (MRF)	Ex.rate (LKR)	Value (LKR)
<b>Opening balance as at 01-01-2014</b>	745,330	2	1,490,660	8.5153	12,693,417
<b>Valuation as at 31-12-2014</b>					

<b>As at 31-12-2013</b>	730,630	2	1,461,260	8.5153	12,443,067
<b>As at 31-12-2014</b>	730,630	10	7,306,300	8.4876	62,012,952
<b>Gain Transferred to AFS Reserve</b>					<b>49,569,885</b>

We identified that these transactions were carried out by the parties within the group with the intention of manipulating the share price. Though we need to value these shares to the active market price we couldn't clearly identify an active market in this scenario.

XYZ Limited was the main company of the group with a large amount of transactions. So the management wanted to show the stakeholders that the company is very profitable and running well. For that purpose during the month of December they have created an active market for these shares by disposing and repurchasing these shares within the group at a price that is much higher than the actual market price of the share.

### **Implication of the Issue**

This manipulation of share prices have resulted a massive increase in the other comprehensive income as well as the Available for sale reserves and impact on the fair Presentation of Financial Statements. Also the Available for Sale Investment balance has been overstated.

### **Conclusion & Recommendation**

Requirement of LKAS 39 Financial Instruments Recognition & Measurement standard is as follows.

**46.** "After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal."

**55 b. (b)** " A gain or loss on an available-for-sale financial asset shall be recognized in other comprehensive income, except for impairment losses (see paragraphs 67–70) and foreign exchange gains and losses, until the financial asset is derecognized"

**48 A.** "The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models."

In this scenario to value KLM PLC shares, the quoted prices in an active market could be used. But as the market prices were manipulated as per the requirements of the standard it was suggested to move for valuation techniques to value these shares. As the valuation technique discounted prices were chosen and Company's **Internal Rate of Return** was taken as the **Discounting Factor** for the calculation.

<b>Valuation as at 31-12-2014 - Available for sale valuation</b>		
Total No of shares as at 31-12-2014	730,630	
<b>If Mark to Market Value considered</b>		
No of shares	730,630	
Market Value	10	
CBSL Exchange rate	8.49	
Total Value of Investments		62,012,952
<b>Using Discounted Prices</b>		
No of shares	730,630	
Price after discounting 30%	7	
CBSL Exchange rate	8.49	
Total Value of Investments		43,421,341
<b>Difference ( Fall in Value )</b>		<b>18,591,611</b>

As per the valuation mentioned above the KLM PLC shares were valued using Share Prices discounted after 30% (IRR). Accordingly the gain identified previously and the investment was reversed back by Rs. 18,591,611 by passing the following J/E.

Available for sale Reserve	Dr	LKR	18,591,611
Available for sale Investment		Cr	LKR 18,591,611