

CHAPTER 1

Related party transactions and disclosures

This article aims to:

- Provides an overview of related parties and RPTs framework and
- Highlight key considerations with respect to various regulatory provisions surrounding related parties and RPTs.



Introduction

Related party relationships and transactions are areas of interest for various stakeholders. Generally, businesses prefer to collaborate with people and organisations they know and trust, however, extensive and complex network that could result in difficulty in identifying related parties and Related Party Transactions (RPTs). This could pose a higher risk of fraud and could reflect a poor governance framework within a company.

Regulators in India and across the globe lay a lot of emphasis on RPTs. Over the past few years, the regulatory authorities have constantly endeavoured to amend regulations relating to RPTs with an intent to increase transparency by requiring detailed disclosures, timely compliances and robust governance provisions. The regulatory framework pertaining to related parties and RPTs has evolved on account of the complexities around this area and the compliance challenges that companies face under various regulations due to complex group structures.

Overview of the regulatory framework

Currently, corporates in India comply with AS 18/ Ind AS 24¹ and the provisions of the Companies Act, 2013 (2013 Act) with respect to RPTs.

Additionally, the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) provides the regulatory framework for the listed entities relating to related parties and RPTs.

Definition of related party

Every company is required to comply with the definition of related party as described under AS 18/Ind AS 24 and Section 2(76) of the 2013 Act. However, SEBI additionally requires following persons to be considered as related parties for listed entities:

- Any person or entity forming part of the 'promoter' or promoter group' of the listed entity
- Any person or any entity, holding equity shares in the listed entity either directly or on a beneficial interest basis as prescribed under Section 89 of the 2013 Act at any time during the immediately preceding financial year:
 - i. 20 per cent or more, or (effective from 1 April 2022)
 - ii. 10 per cent or more (effective from 1 April 2023).

1. Ind AS 18, Related Party Disclosures and Ind AS 24, Related Party Disclosures

Definition of RPTs

The definition of RPT is not specifically provided in the 2013 Act, however, Section 188 of the 2013 Act lists down certain contracts or arrangements that would constitute a RPT. Further, as per Ind AS 24, a RPT is defined as transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

In addition to the requirements under the 2013 Act and the accounting framework, SEBI has expanded the scope of RPTs for listed entities to additionally include the following:

- A listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand, or (effective from 1 April 2022)
- A listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries (effective from 1 April 2023)



Approval of RPTs

The 2013 Act and SEBI Listing Regulations lay down the requirements of approval of Board of Directors and shareholders for RPTs. Section 188 of the 2013 Act requires Board of Directors' approval for transactions with related parties, which are not in the ordinary course of business, and which are not at an arm's length basis. However, in case of a listed company, as per Section 177 of the 2013 Act, an audit committee's approval is required for all transactions with related parties. Further proviso to Section 177(4)(iv) permits an omnibus approval for RPTs proposed to be entered into by the company subject to conditions prescribed in the Rule 6A of the Companies (Meetings of Board and its Powers) Rules, 2014. Regulation 23(4) of the Listing Regulations also provides that audit committees may grant an omnibus approval for a period up to one year if specified conditions are met.

Additionally, SEBI requires listed entities to obtain prior approval of the audit committees for transactions wherein the subsidiary of the listed entity is a party to the transaction, but the listed entity is not a party and the value of such transaction exceeds the below mentioned thresholds:

- 10 per cent of the annual consolidated turnover in accordance with the last audited financial statements of the listed entity (effective from 1 April 2022)

- 10 per cent of the annual standalone turnover in accordance with the last audited financial statements of the subsidiary (effective 1 April 2023)

The material RPTs² should also be approved by the shareholders as per the provisions of the Listing Regulations.

As can be observed from above, the definition of related parties, RPTs and the approval mechanism under the SEBI Listing Regulations are more stringent as compared to the provisions stipulated in the applicable accounting standards and provisions of the 2013 Act.

2. Regulation 23 of the Listing Regulation provides that a transaction with a related party is considered material, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds INR1000 crore or 10 per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity, whichever is lower.



Key considerations for the management to ensure compliance with the regulatory provisions

The management of a company is usually in the best position to identify related party relationships and transactions. Therefore, companies are expected to set up a robust design around identification of related parties, RPTs and approval of RPTs. Certain considerations that management can take note of to ensure appropriate identification, classification and disclosure of related party relationships and transactions are as follows.

Implementing policies, procedures and controls

- a. Internal controls:** The standard Operating Procedures (SOPs), processes and system of internal controls must be appropriately designed and implemented to identify, classify and report related parties and transactions. The processes and controls should be effective to identify exceptional transactions and non-compliances.
- b. Related party policy and group consideration:** Related party policy should be updated to include the requirements of the 2013 Act and the SEBI Listing Regulations. Further, in consultation with the audit committees, the RPT policies should define what constitutes a material

modification based on qualitative and quantitative factors. The management must ensure that a process is in place to periodically review and, if necessary, amend the RPT policy on the basis of any developments.

The related party policy and regulatory requirements relating to RPTs should also be communicated at a group level to all group companies including those based outside India. The management must also ensure that the related party database and organisation chart is updated frequently to take into consideration any deletions and additions of related parties. The accounting manuals of group and component level may be revised on a regular basis to update RPT policies, related party identification procedures, and approval procedures.

- c. Plan for RPTs' approval:** The management must draw up a plan at the beginning of the year for potential RPTs to be executed during the year and an estimate of the volume of the RPTs expected to be entered into should also be determined. Additionally, information should also be

obtained from group companies with respect to the related party transactions proposed to be entered into along with timelines for entering into such transactions. Considering that a prior approvals of the audit committee and shareholders are required for related parties of a listed entity and its unlisted subsidiaries, planning for RPTs at a group level in advance would enable timely approvals and avoid any breach of regulatory provisions.

- d. Transactions to benefit a related party:** The Listing Regulations require the management to analyse transactions entered into with a third party to understand and identify whether the purpose of the transaction is to benefit a related party. The board of directors and management are expected to define the basis for identification of such transactions and set out certain criteria and additional processes for identification of such transactions. The management may also consider updated the RPT policy to specify the criteria used for identifying 'transactions, the purpose and effect

of which is to benefit a related party'. Additionally periodic confirmations from the promoter group, large shareholders and other related parties can also be taken to identify related parties that could benefit from certain transactions.



Arm's length evaluation

An important aspect of corporate governance is to ensure that a RPT, whether routine or non-routine in nature, is undertaken at in the ordinary course of business and at an arm's length price. Accordingly, following are a few key points to be considered:

- Formulating and implementing procedures to evaluate the arm's length basis for RPTs. Also maintain proper documentation to ensure that RPTs are carried at arm's length basis.
- The company's policy should also explain what constitutes 'transactions in ordinary course of business.' Accordingly, it would help to flag exceptional transactions and identify any irregularities/non-compliances.
- Price benchmarking, comparing prices at which similar transactions are undertaken with unrelated parties, obtaining comparative price quotes, comparing the terms of the transaction to known market terms for broadly similar transactions in an open market, transfer pricing study, etc. are some of the methods to determine the arm's length price.
- Consider hiring an external specialist or independent consultants for evaluating the arm's length price for RPTs.

Maintenance of documentation and submission of information

The management must ensure that necessary documentation is in place to facilitate the approval mechanism. Rule 15 of the Companies (Meetings of the Board and its Powers) Rules, 2014 prescribes information to be presented to the board of directors and shareholders while obtaining approval for transactions covered under Section 188(1) of the 2013 Act. However, the 2013 Act does not prescribe the information to be presented to the audit committee for consideration of RPTs. In case of listed entities, SEBI has additionally prescribed³ through its circular the information to be presented before the audit committee and the shareholders when obtaining their approval under the Listing Regulations. This circular includes a comprehensive list of documents and information as compared to that prescribed under the 2013 Act.

Thus, companies need to ensure they meet the information requirements of both regulations. Certain key requirements to be considered that can be provided for obtaining an approval are as follows:

- Name of related party and nature of relationship
- Material terms and tenure of the contract
- Value of the proposed transaction
- Nature of concern or interest (financial or otherwise),
- Transaction value as a percentage of a turnover,

- Justification as to why the RPT is in the interest of the listed entity,
- A copy of the valuation or other external party report, if any such report has been relied upon

Further, the various departments of the company (e.g. finance team, legal team and secretarial compliance team) must coordinate with each other to identify and monitor related party relationships and transactions to ensure timely compilation of information for the purpose of obtaining approvals. Considering volume of disclosure companies may contemplate bifurcating its disclosures into routine and non-routine transactions and may additionally provide a summary of disclosures as a separate table alongwith detailed disclosures. The management of the entity must also coordinate with other group companies to ensure information is collected well within time.

Auditor's consideration relating to RPTs

Verification of RPTs is one of the crucial and challenging areas while performing an audit of the company. Existence of risks of inappropriate accounting, non-identification, non-disclosure of RPTs especially in large and complex groups and risks of fraud are some of the inherent risks in this area that requires an auditor's skepticism to be enormously high. Standard on Auditing (SA) 550 Related Parties deals with related parties which require a risk-based approach for audit of this area. This standard indicates audit procedures required

to be performed as well as illustrates common situations to help an auditor recognise significant risks. The auditors are expected to critically assess the identification and reporting of related parties and RPTs.

Conclusion

There has always been a challenge for identifying RPTs and such transactions are often camouflaged to depict transactions with a non-related company. Therefore, the regulators are constantly working towards tightening the compliance requirements in relation to related party transactions. The regulatory authorities have expanded the scope of accountability and responsibility of not only the management of the company but also the independent directors and audit committee members. Further, the amendments to the Listing Regulations have strengthened the approval and disclosure process of RPTs, enabling audit committee members and shareholders to take informed decisions. The management of the company should ensure that they comply with the spirit of the law and endeavour to provide relevant and detailed information to audit committee members and shareholders.

³ SEBI circular No. SEBI/HO/CFD/CMD1/CIR/P/2021/662 dated 22 November 2021 on disclosure obligations of listed entities in relation to RPTs