

Related party transactions

Insights related to the implementation of increased audit committee responsibilities

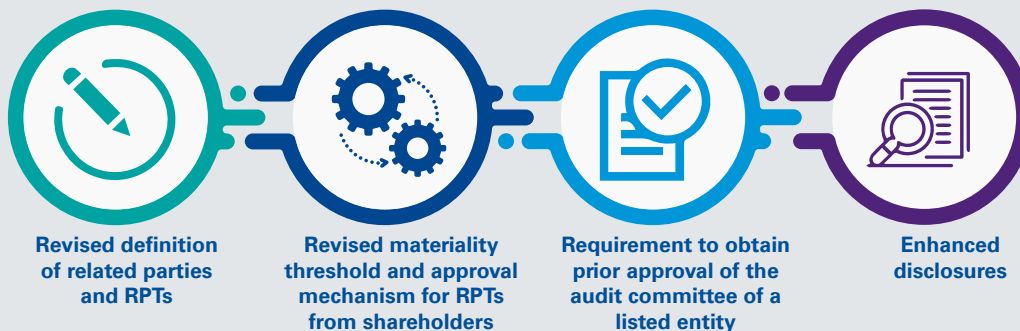
Board Leadership Center (India)

(a seven minutes read)



Currently, corporates in India have to comply with the Indian Accounting Standards (Ind AS) and the Companies Act, 2013 (2013 Act) with respect to Related Parties Transactions (RPTs). Additionally, the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) provide regulatory framework for the listed entities for RPTs.

In order to strengthen the regulatory norms for the listed entities in India, on 9 November 2021, SEBI notified amendments to provisions pertaining to RPTs through the SEBI (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021 (the amendment). Salient points related to these are listed below:



These amendments would be implemented in a phased manner.

Effective date - Few amendments from 1 April 2022 and remaining from 1 April 2023.

Additionally, on 22 November 2021, SEBI issued a circular specifying the disclosure obligations of listed entities (i.e., information to be placed before the audit committee and the shareholders, and the format for disclosure of RPTs to stock exchanges on a six-monthly basis).

For a detailed overview of the amendments, please refer KPMG in India's First Notes on 'SEBI notified amendments to Related Party Transactions' dated 24 December 2021.



SEBI has also provided following clarifications and guidance for smooth implementation of the amended Regulation 23 of the Listing Regulations:



Fresh approval not required from the shareholders

Any transactions that has been approved by the audit committee and shareholders prior to 1 April 2022, no fresh approval is required



Transactions becomes material due to revised materiality threshold

In case RPT approved by the audit committee before 1 April 2022 which continues beyond such date and becomes material as per the revised materiality threshold, then such transactions are required to be placed before the shareholders in the first general meeting held after 1 April 2022.



Omnibus approval by audit committee:

- The RPT for which the audit committee has granted omnibus approval, are required to be placed before the shareholders if it is material in terms of Regulation 23(1) of the Listing Regulations.
- Where the shareholders' approval of omnibus RPTs is obtained in an Annual General Meeting (AGM) then it would be valid up to the date of the next AGM for a period not exceeding 15 months. In case omnibus approvals for material RPTs is obtained from shareholders in general meetings other than AGMs then such omnibus approval would be valid for one year.

Key considerations for organisations, boards and audit committees



Recent financial irregularities in Indian corporate sector has led to amendments to RPTs norms by SEBI. These amendments have widened the scope of related parties manifold. The amendments aim to strengthen the approval and disclosure processes relating to RPTs and the amended provisions would enable audit committee and shareholders to make informed decisions. Some of the key considerations are:

- The increased scope of RPTs requires enhanced scrutiny of transactions, and the underlying processes.
- The audit committee should deliberate with the management to define what constitutes a material modification in order to evaluate if an adequate approval mechanism is in place.
- Companies would be required to establish procedures and processes to correctly classify related parties and transaction entered with these parties. In certain situations, the companies may have number of subsidiaries or a complex related party structure, in such situations the management and audit committee members would also need to identify if the purpose of any transactions is to benefit a related party. Considering the increased scope (due to the amendments) the management, board and audit committee members would need to look deeper into transactions that traditionally would not have been classified as RPTs considering the end beneficiary of the transactions.

The processes would need to be further strengthened to detect those transactions undertaken with seemingly unrelated parties especially for the entities with complex structures. Audit committee members are expected to be vigilant in case of unrelated parties' transaction also, to determine the transactions that ultimately benefit a related party of the entity or of any of its subsidiary and also verify the documentation in this regard. Even though compliance of these norms will be tough, the entities will be required to comply with the amended requirements.

- The change in definition would lead to inclusion of new parties and new transactions within the scope of RPTs. Independent directors, as members of the audit committee, are entrusted with the responsibility to approve RPTs. The amendments have increased onus on independent directors as they have the responsibility to approve RPTs being audit committee members. Independent directors need to critically verify and review related party relationships' and RPTs along with the information and explanation with regard to these transactions to provide timely approvals.
- In relation to transactions submitted for approval, audit committee should request information from the management such as justification for an RPT, why the transaction is in best interest of the company, other details such as material terms, tenure value, transaction value as a percentage of turnover, source of funds (for transaction relating to loans, advances or investments), etc.

- The audit committee is expected to perform its duties effectively and to have the resources and authority necessary to perform its duties. As the duties of the audit committee continue to expand, the audit committee members may engage independent consultants if deemed necessary to perform their duties. Such independent consultants would work with the management and the audit committee members for continuous review and evaluation of RPTs. Evaluating the procedures and processes for classification of related parties and RPTs helps with right identification and justification for RPTs and would also ensure correct and timely approvals, especially for large and complex structures.
- Independent directors would need to verify that entities have the requisite Standard Operating Process (SOP) to ensure that RPTs are carried out on an arm's length basis. It is essential that a solid documentation process exists within the organisation relating to price benchmarking and should indicate the following:
 - a. Prices at which similar transactions are undertaken with unrelated parties
 - b. Comparative price quotes
 - c. Comparable companies' profitability (extracted from external databases) from similar transactions, in the absence of specific pricing related data, etc.
- The amendment has revised the threshold relating to prior approval of the audit committee. The new threshold might lead to increase in the quantum of transactions required to be approved by the audit committee. Audit committee members should evaluate the transactions considering the revised threshold as the new threshold of 10 per cent of the standalone turnover of subsidiary could be low in certain situations and would increase the quantum of transactions.
- The circular dated 22 November 2021 issued by SEBI now prescribes 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. Companies would thus need to ensure that they meet the information requirements of both the regulations.
- The audit committee and the management of the company would need to ensure that they comply with the spirit of the law and endeavour to provide relevant and detailed information to the shareholders. The information so provided to the shareholders should include, but not be limited to, the prescribed information to enable shareholders to make an informed decision.

Questions for the audit committee

Board of directors, audit committee members and all independent directors should evaluate the following parameters:

Whether an entity has carried out all compliances timely in order to identify existing/potential RPT due to the change in the definition?

What are the policies and procedures that ensure compliance with related party regulations and how are such responsibilities communicated?

How are the contracts or arrangements segmented to follow proper channel of approvals?

Does management reviews its materiality policy on RPT specifying the threshold limits on frequent intervals?

How effective are the controls and procedures to flag an exception or an overlooked transaction, if any?

What are the procedures to assess the impact of the related party transaction on the financial statements?

Whether the entity ensures correct documentation on RPT to establish arm's length criteria for the transactions?

Are the disclosures provided to the audit committee and shareholders in compliance with the spirit of the law and provide relevant and detailed information?



The bottom line

In spite of severe norms relating to related parties and RPTs under SEBI Regulations and the 2013 Act, the RPTs continues to be a critical area for audit committees and independent directors from corporate governance perspective. The recent amendment by SEBI aims to further strengthen regulatory norms in relation to RPTs undertaken by listed entities in India. However, board of directors, audit committee members and independent directors are expected to examine RPTs critically to ensure greater transparency and better vigilance in this area.

Considering the spirit of the legislation, the amendments are expected to ensure good corporate governance, though they would increase the compliance for listed entities their management, subsidiaries, audit committees members and independent directors.



We would like to thank our Audit Committee Council Members for their time in providing us with their valuable insights and perspectives that have contributed to building this POV document.

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