

# ASSURANCE INSIGHTS

## RELATED PARTY TRANSACTIONS

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It is common for entities to operate separate functions of their business through subsidiaries, associates, joint ventures or special purpose vehicles. Related parties may enter into transactions on terms that unrelated parties may not. For example, a wholly owned subsidiary may invoice its goods at cost to its holding company and on different terms to third parties. Such transactions may have an impact on the operating results and financial position of the reporting entity when assessed in isolation.

Under the Companies Act, 1956, related party transactions were governed by section 297 and section 314. Related parties and related party transactions were defined under section 297. The Companies Act, 1956 had prescribed that if companies with a paid up share capital of INR 50 million entered into a related party transaction exceeding INR 5000, such a transaction would require the central government's approval. As per section 314, directors were specifically restricted from holding a place of profit in the company unless the same was allowed by a special resolution.

As businesses evolved in India, the possibilities of scenarios where there would arise a conflict of interest for the stakeholders also evolved. The need for good and effective corporate governance was felt in the wake of fraudulent related party transactions which resulted in siphoning of funds, evasion of taxes, misuse of resources and corporate bankruptcy. Transparency is an essential mechanism required to ensure good governance prevails in the organisation. It was with this rationale, shareholder's approval to enter into related party transactions has been made a

prerequisite by the new Companies Act, 2013. The Companies Act, 2013 is seen as a transparent and stakeholder-friendly legislation. Under this, many sensitive dealings which earlier required the central government's approval, will now require shareholders' approval. Aimed towards improving the current state of corporate governance and promoting disclosure oriented management, the Companies Act, 2013 seeks to empower the stakeholders of the organisation in its decision making process. Under this Act, related parties are defined under section 2. Section 188 of the Companies Act, 2013 lays down the compliances for entering into a related party transaction. The erstwhile section 297 and section 314 are now covered under one section 188. Section 188 of the Act read with the relevant rules prescribes the procedures to be followed for entering into related party transactions and material thresholds, exceeding which, shareholders' approval becomes necessary.

The following update highlights the definition and scope, compliance procedures and disclosures to be followed by companies to stay compliant with regulations that govern related party transactions namely the Companies Act, 2013 and the revised clause 49 of the Equity Listing Agreement of the Securities and Exchanges Board of India.

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# Compliance requisites

In case of related party transactions, companies must adhere to the following compliances:

- Section 188 of the Companies Act, 2013 (the Act) - applicable to all companies
- Revised clause 49 of the Equity Listing Agreement (RC 49) - applicable to companies listed on a recognised stock exchange of India

## Definition and scope

### Who are related parties?

The meaning of related parties with reference to companies has been explained in section 2(76) of the Act. This section lays down an exhaustive list of parties who are related to the company.

- A director or his relative<sup>1</sup>;
- Key managerial personnel (KMP)<sup>2</sup> or his relative;
- A firm, in which a director, manager or his relative is a partner;
- A private company in which a director or manager is a member or director;
- A public company in which a director or manager is a director and holds along with his relatives, more than 2% of its paid-up share capital;
- A body corporate whose board, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager, except if advice/directions/instructions are given in the professional capacity;
- Any person on whose advice, directions or instructions a director or manager is accustomed to act, except if advice/directions/instructions are given in the professional capacity;
- Any company<sup>3</sup> which is:
  - A holding, subsidiary or an associate company<sup>4</sup> of such company; or
  - A subsidiary of a holding company to which it is also a subsidiary
- Directors and KMP of the holding company or their relatives.

<sup>1</sup> According to section 2(77) of the Act, the term 'relative' as with reference to any person means anyone who is related to another, if:

- They are members of a Hindu Undivided Family (HUF)
- They are husband and wife, or
- One person is related to the other in the manner as may be prescribed. The draft rules prescribed a list of relatives to include:

Father (including stepfather)	Son's wife	Brother (including stepbrother)
Mother (including stepmother)	Daughter	Sister (including stepsister)
Son (including stepson)	Daughter's husband	

<sup>2</sup> KMP as defined in section 2(51) of the Act:

CEO, Managing Director or Manager	Company Secretary	Such other officer as may be prescribed (yet to be prescribed)
Whole time director	CFO	

<sup>3</sup> The Ministry of Corporate Affairs (MCA) has proposed amendments by notification dated 5 June 2015, applicable only to private companies. This has been laid down in a draft before both the houses of parliament and is yet to be passed. The notification states that in case of a private company - holding, subsidiary and associate companies - are not related parties for the purposes of section 188 of the Act.

<sup>4</sup> According to section 2(6) of the Act, 'associate company' in relation to another company, is defined as a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company. For the purposes of this clause, 'significant influence' means control of at least 20% of total share capital, or of business decisions under an agreement.

**For the purpose of RC 49**, an entity shall be considered to be related to the company if,

- the entity is a related party under section 2(76) of the Act; or
- the entity is a related party under the applicable accounting standards.



The applicable Accounting Standards as per the Indian Generally Accepted Accounting Principles (GAAP) are Accounting Standard 18 (AS 18) Related Party Disclosures and Indian Accounting Standard 24 (Ind AS 24) as applicable to companies.

AS 18	Ind AS 24	Comments
<p>Enterprises that directly or indirectly, through one or more intermediaries, control or are controlled by, or are under common control with the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);</p> <p>Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives<sup>1</sup> of any such individual.</p>	<p>An entity is related to a reporting entity in case of any of the following conditions:</p> <p>i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).</p> <p>ii) A person or a close member<sup>2</sup> of that person's family is related to a reporting entity if that person,</p> <ul style="list-style-type: none"> <li>– has control or joint control over the reporting entity; or</li> <li>– has significant influence over the reporting entity.</li> </ul>	<p><b>AS 18</b> focuses on enterprises and individuals or members of their family to establish a relation between the reporting enterprise and other entities based on control and significant influence.</p> <p><b>Ind AS 24</b> With respect to entities: Focuses on entities being related to one another if they are of the same group.</p> <p>With respect to individuals: Focuses on individuals or members of the individual's family to establish a relationship between the reporting enterprise and other entities based on control and significant influence.</p>
<p><b>Associates and joint ventures</b> Associates and joint ventures of the reporting enterprise and the investing party or joint venture associate of which the reporting enterprise is an associate or a joint venture.</p>	<p><b>Associates and joint ventures</b></p> <ul style="list-style-type: none"> <li>– One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).</li> <li>– Both entities are joint ventures of the same third party.</li> <li>– One entity is a joint venture of a third entity and the other entity is an associate of the third entity.</li> </ul>	<p>Under <b>AS 18</b>, it is debatable whether the parent of the reporting entity and the joint venture or venture associate of the reporting entity are related to each other.</p> <p>Under <b>Ind AS 24</b>, the parent of the reporting entity is related to the joint venture or venture associate of the reporting entity.</p>
<p>KMP and their relatives</p>	<ul style="list-style-type: none"> <li>– KMP of the reporting enterprise as well as its parent</li> <li>– The close family members of the KMP are related</li> </ul>	<p><b>AS 18</b> covers the KMP of the entity and only uses the term relative.</p> <p><b>Ind AS 24</b> covers the KMP of the reporting entity as well as their parents. Dependents are included in the definition of close members of the family used under Ind AS 24.</p>
<p>Not covered under AS 18</p>	<p>The entity is a post-employment benefit plan for the benefit of the employees of either, the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.</p>	<p><b>Ind AS 24</b> includes post-employment benefit plans as related parties, which are not covered under AS 18.</p>

<sup>1</sup> Relative

According to AS 18 'relative' in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealing with the reporting entity.

<sup>2</sup> Close Member of the family

Ind AS 24 defines the term 'close members of the family' as those members of the family who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

- That person's children, spouse or domestic partner, brother, sister, father and mother,
- Children of that person's spouse or domestic partner; and
- Dependants of that person or that person's spouse or domestic partner.

## What are related party transactions?

Section 188 of the Act lays down an exhaustive list of transactions which, if entered into with a related party, shall be construed as related party transactions. These are:

- a) Sale, purchase or supply of any goods or materials;
- b) Selling or otherwise disposing of, or buying, property of any kind;
- c) Leasing of property of any kind;
- d) Availing or rendering of any services;
- e) Appointment of any agent for purchase or sale of goods, materials, services or property;
- f) Such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
- g) Underwriting the subscription of any securities or derivatives thereof, of the company.

The scope of related party transactions under the Act has been widened to include points (b), (c) and (e), which were not covered in the preceding Companies Act, 1956. It is also pertinent to note that the Companies Act, 1956 included only the underwriting of shares and debentures covered in point (g) above.

**As per RC 49**, a related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.

**The definition of related party transactions under RC 49 is much wider in scope than section 188 of the Act.**



## Compliance procedures

Section 188 of the Act applies to related party transactions that are not entered into on an arm's length basis or in the ordinary course of business operation of the company.

### Transactions exempted under section 188

The provisions of section 188 will not apply to a related party transaction in the following case:

The transaction is in the ordinary course of business<sup>1</sup>; and the transaction is an arm's length transaction<sup>2</sup>.

<sup>1</sup>The concept of 'Ordinary Course of Business' has not been defined in the Act. Ordinary course of business can be taken to mean any matter which transpires as a matter of daily custom in business as has been laid down in the objects clause of the memorandum of association of the company.

<sup>2</sup>Arm's length transaction is defined as a transaction between two related parties that is conducted as if they were unrelated, so that there is no

Transactions between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. This has been notified as per the Companies Amendment Act, 2015 issued on 26 May 2015 in the Official Gazette. However, the MCA has not appointed a date for the enforcement of this provision.

## Approval thresholds

According to section 188 of the Act, entering into a related party transaction requires prior approval of the Board of Directors of the company. Additionally, shareholders, through an ordinary resolution in a general meeting, must give their consent to related party transactions in case they exceed the under mentioned thresholds:

Nature of transaction	Threshold limit as per the Act read with the Companies (meetings of Board and its powers) Second Amendment Rules, 2014 GSR 590(E) issued on the 14 August 2014 (Rule 15 sub-rule 3)
Sale, purchase or supply of any goods or materials (directly or through an agent)	Lower of, transaction value exceeding 10% of turnover; or INR 1 billion
Availing or rendering of any service (directly or through an agent)	Lower of, transaction value exceeding 10% of net worth; or INR 500 million
Appointment to any office or place of profit in the company	Remuneration exceeding INR 250,000 per month
Underwriting the subscription of any securities or derivatives of the company	Remuneration exceeding 1% of net worth
Selling or otherwise disposing of, or buying property of any kind (directly or through an agent)	Lower of, transaction value exceeding 10% of net worth or INR 1 billion
Leasing of property of any kind	Lower of, transaction value exceeding 10% of turnover or net worth or INR 1 billion

- Turnover is as defined in section 2(91) of the Act
- Net worth is as defined in section 2(57) of the Act
- The turnover or net worth referred in the above sub-rules shall be on the basis of the Audited Financial Statement of the preceding financial year as per the explanation to rule 15 sub-rule 3

If the company in question has a paid-up capital of INR 100 million or more, irrespective of whether the material thresholds are exceeded, it shall have to take the shareholders' approval by an 'ordinary resolution' prior to entering in the said transaction. Previously, the Act mandated 'special resolutions' of the shareholders as the approval mechanism. Ordinary resolution has been notified as per the Companies Amendment Act, 2015 issued on 26 May 2015 in the Official Gazette. However, the MCA has not appointed a date for the enforcement of this provision.

In case of wholly owned subsidiaries, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transaction between the wholly owned subsidiary and holding company.

## Forms, registers and approvals

### Disclosure of interest by Directors as per section 184 of the Act

#### Content of disclosure

Every director is required to make a disclosure of his concern or interest in any companies or body corporates, firms or other associations of individuals by giving a notice in the Form MBP-1<sup>1</sup>

#### Timing of making disclosure

It is the duty of the director to give a notice of interest and cause it to be

disclosed at the Board meeting held immediately after the date of the notice

#### Maintenance of disclosures made by Directors

All the notices furnished by the Directors in Form MBP-1 have to be kept and preserved at the registered office in the custody of the company secretary or any other person authorised by the company

for a period of eight years from the end of the financial year to which they relate to.

<sup>1</sup> Form MBP-1 is a form prescribed in the Company (Meetings of the Board and its powers) Rules, 2014 issued on 27 March 2014, vide GSR 240(E) in pursuance of section 184 of the Act. The form prescribes the format in which of disclosure of interest and concern is to be made by the Directors.

## Register to be maintained by the company as per section 189 of the Act

Every company shall maintain a register in Form MBP-4<sup>1</sup> and shall enter the following in the register:

- Company or companies or bodies corporate, firms or other associations of individuals, in which

any Director has any concern on interest. (the disclosure of the same is given in Form MBP-1);

- Contracts or arrangements with the related party with respect to transactions to which section 188 applies;

- Contracts or arrangements with the body corporate or firm or other entity, in which any Director is, directly or indirectly, concerned or interested as per section 184.

<sup>1</sup>Form MBP-4 is a format of a register prescribed in the Company (Meetings of the Board and its powers) Rules, 2014 issued on 27 March 2014, vide GSR 240(E) in pursuance of section 189 of the Act.

## Approval of the Board to related party transactions

The Board of Directors of the company shall give their assent in the form of a Board resolution to related party transactions to be undertaken. The agenda of the Board meeting at which the resolution is proposed to be moved shall disclose:

- The name of the related party and nature of the relationship;

- The nature, duration, material terms, including value, if any, and particulars of the contract or arrangement;
- Details of advance paid or received, if any;
- The manner of determining the pricing and other commercial terms, both included as part of the contract

and not considered as part of the contract;

- Consideration of all relevant factors and rationale for not considering a factor, if any;
- Any other relevant information required by the Board to arrive upon a decision on the proposed transaction.

## Approval of the shareholders to related party transactions

An explanatory statement is to be annexed to the notice of a general meeting of shareholders and shall contain the following particulars:

- Name of the related party;

- Name of the Director or KMP who is related, if any;
- Nature of the relationship;
- Nature, material terms, monetary value and particulars of the contract or arrangement; or

- Any other information relevant or important for the members to take a decision on the proposed resolution.

## For the purposes of RC 49

The approval of the Audit Committee must be sought prior to entering into a related party transaction. The Audit Committee is empowered to grant an omnibus approval to related party transactions subject to the value of the transaction not exceeding INR 10 million. Shareholders must give their assent to related party transactions in case they exceed the material thresholds as prescribed under RC 49(VII) C of the Equity Listing Agreement. This approval is in the form of a special resolution given in the general meeting. The material thresholds are as under:

- If the transaction to be entered into individually or taken together with previous transactions during a financial year exceed 10% of the annual consolidated turnover as per the last audited financial statements, such transaction shall be considered material i.e. exceeding the material threshold.

**No provisions exist for ratification in case prior approval is not sought for the purposes of RC 49.**



For all those companies who are mandated to formulate an Audit Committee as per section 177 of the Act, the Audit Committee may grant an omnibus approval giving its assent to related party transactions. This provision has been notified as per the Companies Amendment Act, 2015 issued on 26 May 2015 in the Official Gazette. However, the MCA has not appointed a date for the enforcement of this provision.

In case prior approval of the Board or shareholders is not taken, the Board or the shareholders, as the case may be shall ratify the transaction within 90 days. In case the ratification is not received, the transaction shall be voidable at the option of the Board.

## Restrictions on voting

In order to comply with section 188 and RC 49, the following restrictions on voting need to be considered for the resolutions to be passed.

Compliances	Board's approval	Shareholders' approval	Audit Committee approval
Section 188	Director's approval is required if an interested related party to the transaction cannot be present for the Board resolution to be passed, giving assent to the transaction.	Required if an interested related party to the transaction is not allowed to cast his vote in the ordinary resolution to be passed giving assent to the transaction.	Impact will be felt if the said Director is a part of the Audit Committee.
RC 49	Not applicable	Required if the related party, whether interested in the transaction or not, is not allowed to cast his vote in the special resolution to be passed, giving assent to the transaction.	Not applicable

The amendments as proposed by the MCA by a notification dated 5 June 2015 applicable only to private companies has been laid down in draft before both the houses of parliament. The notification states that:

- An interested Director, post disclosure of his interest, may participate in the Board meeting wherein the Board resolution for related parties is being given.
- Shareholders, if interested in the transaction, can vote in the ordinary resolution for giving assent to related party transactions that exceed the thresholds as discussed in rule 15 above.

**RC 49** applies to all related party transactions irrespective of whether they are in ordinary course of business and an arm's length basis. The only transactions exempted from compliance under RC 49 requirements are:

- Transactions between two government companies;
- Transactions between a holding company and its wholly owned subsidiary whose accounts are consolidated with the holding company and placed before the shareholders at the general meeting for approval.



## Disclosures

### Disclosures in the Board's report

Disclosures in the Board's report as mandated by the Act are as follows:

- As per section 188(2), every related party transaction shall be referred to in the report of the directors to the shareholders along with the justification for entering into the contract or agreement.
- As per section 134(3)(h), a statement attached to the Board's

report which lays down particulars of contracts or arrangements with related parties referred to in the prescribed form. This disclosure shall be made in the general meeting

Disclosures for related party transactions as per RC 49(VIII) A of the Equity Listing agreement are as follows:

- Details of all material transactions with related parties shall be disclosed quarterly along with the compliance report on corporate governance.
- The company shall disclose the policy on dealing with related party transactions on its website and a web link thereto shall be provided in the Annual Report

### Disclosures in financial statements

AS 18	Ind AS 24	Comments
Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.	Relationships between a parent entity and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them.	According to <b>AS 18</b> , the emphasis is on related parties where control exists.  <b>Ind AS 24</b> states that relationships between entities being the parent and its subsidiaries shall be disclosed irrespective of the transactions between them.

AS 18	Ind AS 24	Comments
<p>If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:</p> <ul style="list-style-type: none"> <li>• name of the transacting related party;</li> <li>• a description of the relationship between the parties;</li> <li>• a description of the nature of transactions;</li> <li>• volume of the transactions either as an amount or as an appropriate proportion;</li> <li>• any other elements of the related party transactions necessary for an understanding of the financial statements;</li> <li>• the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and</li> <li>• the amount written off or written back in the period in respect of debts due from or to related parties.</li> </ul>	<p>If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments necessary for users to understand the potential effect of the relationship on the financial statements.</p> <p>At a minimum, disclosures shall include:</p> <ul style="list-style-type: none"> <li>• the amount of the transactions;</li> <li>• the amount of outstanding balances, including commitments, <ul style="list-style-type: none"> <li>– their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and</li> <li>– details of any guarantees given or received;</li> </ul> </li> <li>• provisions for doubtful debts related to the amount of outstanding balances;</li> <li>• the expense recognised during the period in respect of bad or doubtful debts due from related parties;</li> <li>• provisions for doubtful debts related to the amount of outstanding balances; and</li> <li>• the expense recognised during the period in respect of bad or doubtful debts due from related parties.</li> </ul> <p>The above-mentioned disclosures shall be made separately by each of the following:</p> <ul style="list-style-type: none"> <li>• the parent;</li> <li>• entities with joint control or significant influence over the entity;</li> <li>• subsidiaries;</li> <li>• associates;</li> <li>• joint ventures in which the entity is a joint venture associate;</li> <li>• KMP of the entity or its parent; and</li> <li>• other related parties.</li> </ul>	<p><b>AS 18</b> required disclosure relating to the amounts written off or written back from or to the related party during the financial year whereas the same is absent in Ind AS 24.</p> <p>However, <b>Ind AS 24</b> requires disclosures such as:</p> <ul style="list-style-type: none"> <li>• the amount of outstanding balances including commitments,</li> <li>• the terms and conditions of such transactions including whether they are secured and the nature of the settlement provided for settlement,</li> <li>• provision for the doubtful debts created for such party and the expense recognised during the period in respect of bad or doubtful debts due from such related party.</li> </ul> <p>Ind AS 24 also requires that such disclosures be made by each of the following party:</p> <ul style="list-style-type: none"> <li>• the parent;</li> <li>• entities with joint control or significant influence over the entity;</li> <li>• subsidiaries;</li> <li>• associates;</li> <li>• joint ventures in which the entity is a joint venture associate;</li> <li>• KMP of the entity or its parent; and</li> <li>• other related parties.</li> </ul>
<p>Not applicable</p>	<p>An entity shall disclose KMP compensation in total and for each of the following categories:</p> <ul style="list-style-type: none"> <li>• short-term employee benefits;</li> <li>• post-employment benefits;</li> <li>• other long-term benefits;</li> <li>• termination benefits; and</li> <li>• share-based payment.</li> </ul>	<p>According to <b>Ind AS 24</b>, the entity should disclose the remuneration paid to the KMP under the categories mentioned under Ind AS 24.</p> <p>This categorical disclosure is not required under AS 18.</p>

## Sources

- The Indian Companies Act, 1956 issued by the Ministry of Corporate Affairs
- The Indian Companies Act, 2013 issued by the Ministry of Corporate Affairs
- Revised Clause 49 of the Equity Listing Agreement issued by the Securities and Exchanges Board of India
- Accounting Standard 18: Related Party Transactions - Issued by the Institute of Chartered Accountants of India
- Indian Accounting Standard 24: Related Party Transactions issued by The Ministry of Corporate Affairs
- The Companies Amendment Act, 2015 issued by the Ministry of Corporate Affairs
- Circulars, Orders and Notifications issued by The Ministry of Corporate Affairs and the Securities and Exchanges Board of India

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