BENNETT, COLEMAN & CO LTD
THE ECONOMIC TIMES

HOLLYWOOD STUDIOS VIE FOR DELHI-6 RIGHTS
BUSINESS OF BRANDS: PAGE 16

MERCK TO BUY SCHERING-PLOUGH
CORPORATE: PAGE 7

INDIANS CAUGHT IN WEB OF ADDICTION
EMERGING BUSINESS & IT: PAGE 6

LORE | CHANDIGARH | CHENNAI | HYDERABAD | KOCHI | KOLKATA | LUCKNOW | MUMBAI | PUNE WWW.ECONOMICTIMES.COM TUESDAY 10 MARCH 2009 | NEW DELHI | 20 PAGES | Rs 2.50 or Rs 4.25 ALONG WITH

DEBATE

# How to regulate related-party transactions

## Enhance capacity to detect RPT frauds

SUMANT BATRA
SENIOR PARTNER
KESAR DASS B & ASSOCIATES*

THE Satyam episode has shocked all and sundry. The fraud is a horrifying testimony of how even the elementary tenements of corporate governance can be ruthlessly and shamelessly flouted right amidst a high calibre board with independent directors, reputed auditors, experienced institutional investors and creditors. With decks cleared for the sale of Satyam, it is now time for policymakers to sit back and mull over lessons learnt from the Satyam saga.

One such lesson surely is the need to monitor and curb abusive related party transactions (RPTs). While RPTs are normal feature of commerce to permit flexibility in business and make room for private contractual arrangements, they can become mechanism in the hands of promoters for extracting private benefits at cost of other shareholders and stakeholders. In India, where relationship-based systems can be far more important than the explicit arm's length systems of corporate governance, the risk of RPTs is much higher. Transactions are generally routed through entities indirectly controlled by a promoter group or management. Founders and families owning the business tend to keep disproportionate share of control in these companies.

Where such companies deal with associate companies, possibilities of dominant shareholders indulging in RPTs is higher. This imbalance between ownership and control creates opportunities for transferring money or assets from company to dominant corporate owner or director, as appears to have been done by Ramalinga Raju to benefit companies owned by his family. Tunnelling of assets out of firms for the benefit of those who control them is a serious concern in business groups with pyramidal ownership structures and inter-firm cash flows.

Prior consent of the board of directors is required for contracts with a firm in which a director or his relative is a partner, or with a private company of which the director is a member or director. For companies having paid-up share capital of not less than Rs 1 crore, previous approval of the central government is required. It is a function of the board to monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in RPTs. Contract without approval is voidable at the option of the board. Every director, directly or indirectly, concerned or interested in an arrangement must disclose it to the board, and abstain from ensuing discussions and voting. Failure by a director to make disclosure is punishable with fine. These requirements are however, only symbolically observed in practice. The boards need to take the task assigned to them by law with all seriousness. Non-related directors must probe these transactions adequately. Independent directors have much higher responsibility in this regard.

*Though India has a fairly decent legal regime for regulating RPTs, there is scope for improvement*

India could do better in many areas, including the approval, monitoring and curbing of the RPTs. Though India has a fairly decent legal regime for regulating RPTs, there is scope for improvement. Only a few RPTs such as loans to directors and facility of holding of office or place of profit by a relative of a director require shareholder approval. Enforcement remains the soft underbelly of India's legal and corporate governance systems. The company law empowers government to inspect books of accounts of company, direct special audit, order investigation into the affairs of a company and launch prosecution. Petitions can be filed for disgorgement of assets against directors responsible for misappropriation/misfeasance. A variety of powers to sanction directors and companies is vested with the government. The government needs to enhance its infrastructure and capacity to detect RPT-related frauds and take suitable remedial measures in a timely manner. A dedicated study of RPT issues would be useful in identifying the policy steps required to be taken to address the problem.

*(* Delhi-based corporate & commercial lawyers)*

## Public & investors must turn more active

PREETI MALHOTRA
PAST PRESIDENT
ICSI*

IDEALLY, directors should keep their fiduciary duties over their personal interests in case of a dichotomy between the two, but in the real world this principle is not always followed. In the absence of adequate disclosure, to identify related parties (RPs) and Related Party Transactions (RPTs) is not easy either. Siphoning off funds through a web of transactions with group companies and entities controlled by management is a powerful tool in the hands of some unscrupulous promoters. Specially, in the backdrop of the Satyam episode where funds were diverted through group companies, the identification, disclosure and approval of RPTs become very important for a stringent regulatory framework.

The current provisions in the Companies Act are director-centric and they include only the person, companies and firms in which directors are interested directly or indirectly for being an RP. Any other company, firm or entity in which directors are not interested but the company itself has some interest or association should also come within the ambit of the Act. The JJ Irani Committee on the basis of which the new Companies Bill has been framed tried to widen the scope of related parties and recommended that details of transactions between the company and its subsidiaries, fellow subsidiaries and associate companies be brought under the umbrella of RPTs. Such transactions should be placed before the Board through the Audit Committee. Details of transactions with such related parties which are not on arm's length basis or not in the normal course of business should form part of the annual report of the company along with management justification thereto.

*Sufficient disclosure of information on top management is the key. Penalties for non-compliance should be stringent*

The committee had said transactions beyond a threshold limit should be approved by the shareholders by special resolution to make sure that those transactions do not result in 'value stripping'. However, the Board of directors and the audit committee should carefully apply their mind to see that for the company for which they are morally responsible, all transactions result in maximum accretion of value into the company or minimum outgo of funds or resources from the company.

Some shareholder activism by strategic investors/FIs/FIIs specially like the one we saw in the case of Satyam wherein the management was forced to change the decision to invest the so-called surplus funds in Group companies was one of its kind and we hope to see the Public/ Investors being more active in future. This will be possible through the regime of e-governance being proposed in the Bill.

In India, as per AS-18, the relevant accounting standard, two or more parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Some of the common requirements enacted to nip the evil of RPTs are disclosure of information regarding the top management team and substantial shareholders of companies in Annual Reports of companies as well as to the government.

Clause 49 of Listing Agreement provides for mandatory review of all RPTs by the audit committee at periodic internals. Under this clause, the details of material individual transactions with RPs which are not an arm's length basis should be placed before audit committee together with management's justification for the same. In case of failure to make disclosures, they should be held liable to strict penalties and be deemed to have vacated their office.

A certificate from the Auditor or the Practising Company Secretary after having undertaken a detailed Audit of the RPTs should form part of the Board's report. Further, penalties for non-compliance and non disclosures should be made very stringent.

*(*Institute of Company Secretaries of India)*