



Related Party Transactions

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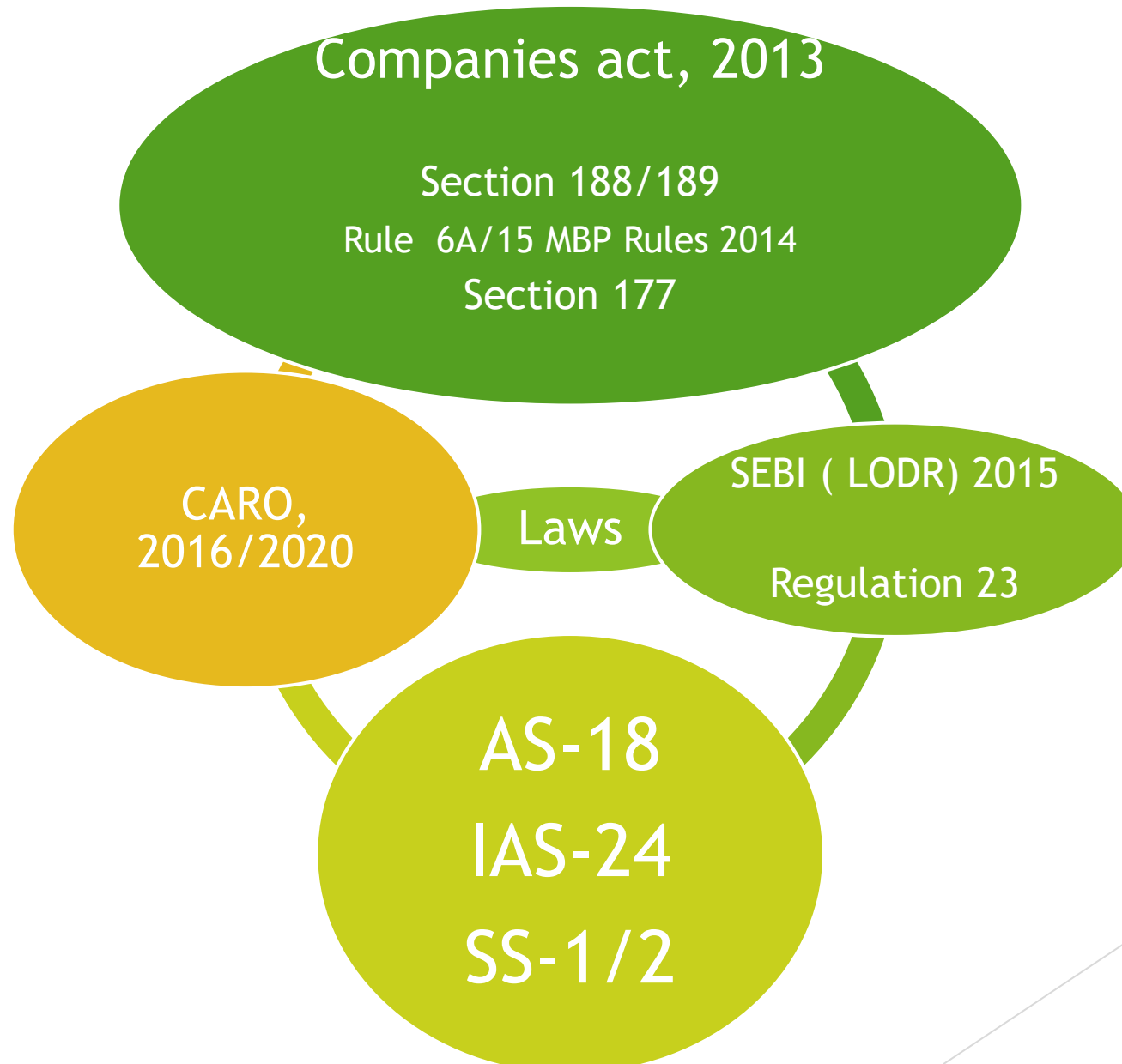
INTRODUCTION

- ❖ A Company, in the course of conduct of its business, enters into various transactions with different parties, including its *related parties* also. (*mostly with subsidiary/associate companies*)
- ❖ Related parties may enter into transactions that unrelated party may not e.g. Related party may get *favoured treatment* In terms of pricing/credit period.
- ❖ Why law has made stricter provisions in terms of compliance & disclosure requirement for RPT:
 1. *Higher chances of abuse of relationship;*
 2. *Conflict of interest;*
 3. *Transactions not on arm's length basis. ;*
 4. *Siphoning of funds;*

Every transaction with a related party may not be “related party transaction” Although every “related party transaction “ is necessarily a transaction with a related party.

Every contract is an agreement but it is not necessary that every agreement may become contract.

Governing Laws



Definitions:

i. Ordinary course of business-

- The act uses the term ‘ordinary course of business’, however it does not define the said term.
- In common parlance, ‘ordinary course of business’ would include transactions which are entered into the normal course of the business in order *to promote or in the furtherance of company’s business objectives*, as per the charter documents of the company.

Whether acquiring another company for the purpose of diversification will be considered in the ordinary course of business or not?

Factors

- ✓ Whether activity is covered in the *object clause of MOA*;
- ✓ Whether activity is in *furtherance of the business*;
- ✓ Whether the activity is *repetitive/frequent*;
- ✓ Whether the *income, earned* from such activity is treated as *business income* in the company's books of account;
- ✓ Whether the transactions are *common* in the particular industry;
- ✓ Whether there is any *historical practice* to conduct such activities;
- ✓ *Resources* committed to the activity;
- ✓ *Revenue* generated by the activity.

Q: Who determine that the transaction with the related party is in the ordinary course of business?

AUDIT COM'TEE/BOD

▶ **MOA :**

- MOA should be referred for ascertaining whether the activity falls in the object clause or not.
- It is not an conclusive test,

▶ ***Policy on RPT:***

- Company's policy on RPT shall specify the parameters to guide the ACB for ascertaining whether the particular transaction is in the ordinary course of business or not.
- **The listed companies are required to formulate its policy on related party transaction and also display in its website in terms regulation 23 of LODR**

▶ ***Guidelines:***

- Company may frame guidelines approved by ACB/BOD, so that company can enter into transaction based on approved guidelines and every transaction need not be required to place before ACB for such purpose.

‘Arm’s Length Transaction’

- Explanation to sub-section (1) of section 188 of the act defines the term Arm’s Length Transaction means transaction between two related parties that is *conducted as if they were unrelated*, so that there is *no conflict of interest*.
- Arm’s Length Basis does not mean *arm’s length price*, as price is just one of the components of the terms of dealing with related party.
- Transaction as a whole and the **entire bundle of T&C** shall be considered while determining whether transaction is on arm’s length basis or not.
- **Illustration:** suppose company A sell x product to company B for Rs.100 and it also sell the same product to it’s subsidiary company for Rs.100 as well.

However based on the price only it cannot be term as arm’s length, as one has to see other terms & conditions as well. Like credit period.

Arm's Length Transaction under Income Tax Act, 1961

- ▶ In terms of *section 92F* : Arm's length price means a price which is applied or proposed to be applied in a transaction between person other than associated enterprise, in an uncontrolled conditions.
- ▶ Methods as per *section 92C*:

Comparable
uncontrol
price method

Resale price
method

Cost plus
method

Profit split
method

Transaction
net margin
method

Q: Is it compulsory to obtain certificate from valuer every time? How do you satisfy the criteria of Arm's length pricing?

- ▶ One may check the *comparable product* in the market.
- ▶ *T & C* of similar transactions.
- ▶ *Price* in isolation cannot be only criteria. Other T & C also required to be checked. (like credit period/quality)
- ▶ Certificate from *management/internal auditor*- it all depends on company policy on RPT.

Who is a related party

- ▶ According to section **Section 2(76)** of the act a related party with reference to a company means-

(i) A director or his relative

(ii) A KMP or his relative

(iii) A firm in which a director or manager or his relative is a partner

(iv) a *private company* in which a director or manager or his relative is a director or member

- (v) a *public company* in which a director or manager is a director and hold along with his relative > 2 % of it's paid-up share capital.

(vi) A body corporate who's board of directors or managing director or manager is *accustomed to act* in accordance with the advice, instructions or direction of director/manager

- (vii) Any person on who's advice or direction or instruction a director or manger is accustomed to act. (except under a professional capacity)

(viii) Any body corporate which is-

- A. holding, subsidiary or an associate company of such company;
- B. Subsidiary of holding company to which it is also subsidiary;
- c. Investing or venturer of the company.

(ix) Such other persons as may be prescribed

Director (except I.D)

KMP of holding company or his relatives

Relatives as per section 2(77) & Rule 4 of companies (specification of definition details) rules 2014:



Related party as per Regulation 2(1)(zb) of LODR 2015

- ❖ A related party means a related party as defined under section ***section 2(76)*** of the act or under the applicable ***accounting standards***(i.e. AS-18/IAS 24).
- ❖ Provided that an person or entity belonging to promoter or promoter group of the listed entity and ***holding 20% or more shareholding*** in the listed entity shall be deemed to be related party.(w.e.f. 1 st April 2019.)

What are related party transactions?

- ▶ Related party transactions as *per section 188(1)* of the act-

(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

What are related party transactions?

(d) Availing or rendering of any services;

(e) Appointment of any agent for the purchase, 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 or associate company;

(g) Underwriting the subscription of any securities or derivatives thereof, of the company.

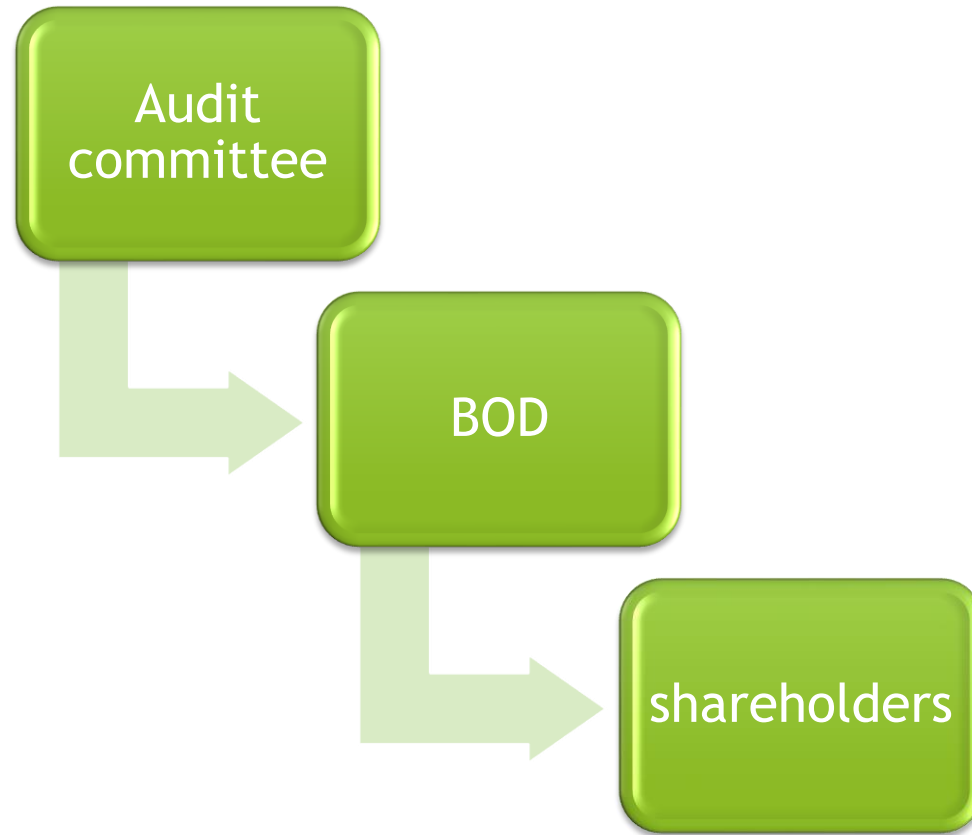
As per LODR 2015

- ▶ ***Regulation 2(1)(zc) :***
- ▶ related party transaction means ***transfer of resources, services or obligation*** between a listed entity and a related party, regardless of whether price is charged. (AS-18/IAS-24 contains the same definition)

Whether issue of shares/debentures will be covered under the ambit of section 188 of the act?

- ❑ Shares are treated as goods once allotted (section 2(7) Sale of goods act 1930).
- ❑ It will be treated as transaction with a related party but not be regarded as related party transaction under 188, provide valuation parameters are met.(in case of private placement/preferential allotment).
- ❑ However transfer of securities would be considered as related party transaction. As same is covered under the definition of term 'goods'

Process/approvals for entering into RPT



Audit committee Approval-Section 177

- ▶ ALL companies which are required or which has constituted ACB voluntarily, requires to take **approval**(not recommendation) of ACB for all the transactions to be entered with related party.(including subsequent modifications).
- ▶ Considering section 177 does not refer to section 188, **approval of ACB is required for all the RPTs**, irrespective whether they are in the ordinary course of business or not or on arm's length basis.
- ▶ In case transaction involving amount **not exceeding Rs.1 cr** is entered into by director or officer of the company without approval of ACB and if it is not ratified by ACB within **3 months** from entering than it is **voidable** at the option of ACB.(if it is with related party of director/authorized by other director than director concern shall indemnify such loss to the company)

Rule 6A - *Omnibus Approval*

- The ACB shall, after obtaining approval of BOD, specify criteria, which shall include the following-

Maximum value in aggregate in a year

Max. value per transaction

Level of disclosures

Review

- (at least on quarterly basis)

Transaction which cannot be allowed under omnibus route

- (selling of undertaking)

Repetitiveness & justification

- In the Interest of the company

Omnibus approval

Name of related party

Nature and duration of transaction



Omnibus approval

Maximum amount of transaction

Base price/contracted price



Omnibus approval

Other important information

Relevant information

→ *Omnibus approval is valid for an maximum period of 1 F.Y and shall require fresh approval after expiry of such F.Y*

Q-Where transaction are between holding company with it's WOS, whether 177 be attracted?

- ▶ Such transaction does not require approval of ACB[4th proviso of sub regulation (iv) of 177 & regulation 23 of LODR).
- ▶ However it is pertinent to note that if transaction is falling under the scope of 188(1), than is not exempted, hence requires approval.

Approval by BOD -188(1)

1. Section 188(1) provides that approval of RPTs mentioned under clause (a) to (g) of the sub section cannot be entered by the company without the approval of board at the ***board meeting only***.
- 2 that means it cannot be done through ***CR***.
3. However approval of BOD is not required for the transactions which are in the ***ordinary course of business & on arm's length basis***.(4th proviso).

Conditions -Rule 15(1) of MBP rules 2014- Agenda shall disclose the following-

Name

Material terms/pricing

Particulars of contract

Advance paid/received

Manner of determining
pricing/other terms

All relevant factors
considered or not

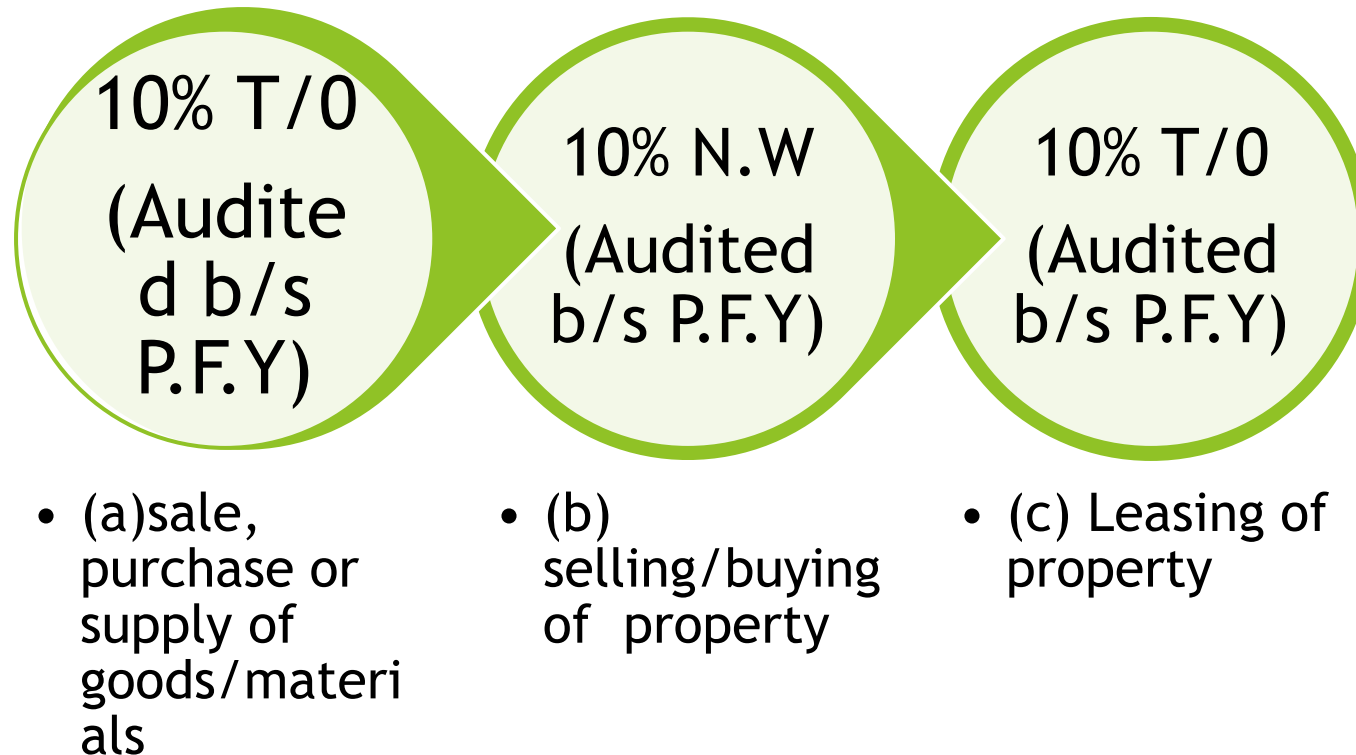
Interested party

- ▶ **Rule 15(2) & para 3.2 of SS-1** clearly provides that if a director is interested in a contract or arrangement with an related party, than he shall not be allowed to participate/vote in that item of agenda.
- ▶ In other words concern director is not allowed to attend the meeting during such discussion, hence he should leave the meeting during such discussion on the subject matter of contract.

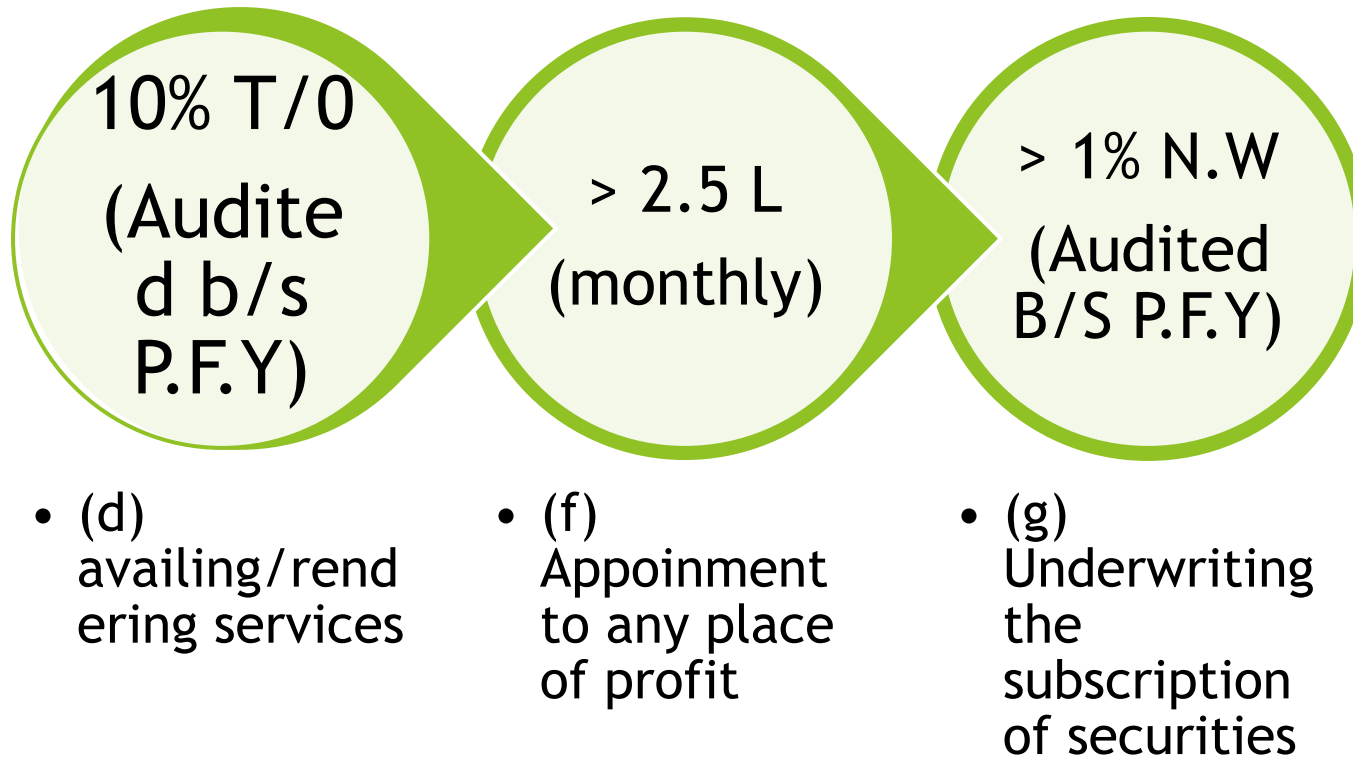
Q. In case of public company there are only 3 directors and all are related to each other and also interested in a particular item. What will be the consequences in such a situation ?

- ▶ The only way is to place the matter before the G.M, as only dis-interested director can approve the item.
- ▶ Also at the G.M if 90% or more members in numbers are related to promoter or related party than they can vote also.[3rd proviso of 188(1)].
- ▶ in case of private company the above restrictions will not apply, subject to disclosure is interest is made at the meeting.(Notification No.GSR464(E), dated 05-06-2015)

Threshold- Ordinary resolution at G.M



Threshold- Ordinary resolution at G.M



Material RPT- LODR 2015

- ▶ ***Regulation 23(1)*** prescribes that Transaction with related party shall be considered material if the transactions to be entered into individually or taken together with previous transactions during a F.Y ***exceeds 10% of annual consolidated T/O*** of listed entity as per the last audited financial statements.
- ▶ Payment made w.r.t brand usage or royalty shall be considered material if it ***exceeds 2%***.

Exemptions from shareholders approval

- i. in case of transactions between Hol.co. & WOS- resolution passed by parent company is sufficient(i.e WOS is not required to pass OR in G.M).
- ii. In case accounts are consolidated with the parent co. & placed before the shareholders at G.M then no such prior approval is required by holding company.(i.e post-transaction approval is sufficient).
- iii. Between two Government companies.(i.r. whether listed or not).
- iv. Unlisted Government company with persons other than Government companies.(subject to prior approval of concern ministry).
- v. Transactions which are in the ordinary course of business & on arm's length.(except material RPT- as per LODR)

Members not entitled to vote-

- ▶ Second proviso to section 188(1) provides that no member of the company shall vote on such resolution, to approve any contract or arrangement , if such member is a related party in context of such contract .(MCA clarification vide circular No.30/2014 dated 17th July 2014)
- ▶ Above restriction will not apply to-
 - private company / IFSC company.(subject to no default made in filling AOC-4/MGT0-7)[Notification dated 13th June 2017].
 - 90% members are relatives of promoter or related parties

AS per LODR 2015

Regulation 23

- ▶ It states that all Material related party transactions shall require approval of the shareholders and no related party shall vote to approve such transaction irrespective whether the entity is a related party to the particular transaction or not.

Section 188(1)

- ▶ While second proviso only restrict the members from voting who are related party to the particular transaction/contract.

Disclosures of RPTs- under C.A 2013

- CARO 2016/2020- In terms of the companies(Auditor's Report) Order, 2016 the Auditor's report on the financial statements of the company shall include a statement on whether all transactions with related party are in compliance with section 177 & 188 of the act.
- Section 134(3) of the act read with rule 8(2) of the companies (accounts)rules, requires all companies to disclose in the Board's report, particular of contract or arrangement with related parties in form AOC-2.
- Extent of disclosure in AOC-2-
 - ❑ Related party transactions which are entered into not on arm's length basis.
 - ❑ Material related party transactions(i.r whether on arm's length or not).
 - ❑ It shall be signed by the persons who have signed the board's report(since it is the part of annexure to board's report).

Under LODR 2015

- ▶ Schedule V of listing regulations requires disclosure on materially significant related party transactions that may have potential conflict of interest in the C.G section of annual report.
- ▶ Disclosure of transactions with any person belonging to the promoter/ promoter group which holds 10% or more shareholding in the listed entity.(w.e.f march 31, 2019)
- ▶ Regulation 27 (2)- quarterly disclosure of all the material RPTs in the compliance report of C.G- 21 days (previously 15 days).
- ▶ Regulation 33- half year disclosure of RPT on consolidated basis within 30 days from the publication of half year financial results.(w.e.f march 31, 2019)

Registers to be maintained -MBP-4

- ▶ Section 189 requires following details to be entered w.r.t RPTs -

Contracts or arrangements with related party to which section 188 applies.



Authenticated by CS / person authorized by BOD



Placed before the board in the next B.M for signature of all the directors.

Consequences- Transactions entered without approval of BOD/Shareholders-

- ▶ In case any transaction is entered into by a director or officer of the company without obtaining the approval of the BOD, Shareholders, as the case may be than it can be ratified by the company within a period of 3 Months from the date of entering.
- ▶ However if it is not ratified as mentioned above than it can be voidable by BOD/shareholders as the case may be.
- ▶ And if the transaction is with a director's related party or is authorized by any other director, the director concerned shall indemnify the company against any loss incurred by the the company from such transaction.

Standard practice

- ▶ One time effort should be made to identify all the related parties, specially when company has multiple subsidiaries
- ▶ MIS can be done periodically to update the information.
- ▶ Identify the ordinary course of business in relation to the company.
- ▶ identify transaction with RPTs.
- ▶ Process can be established for obtaining internal clearance before entering into transaction.
- ▶ Collate documentation for arm's length basis of transactions with related parties.
- ▶ Establish system control to track related parties and transactions with such parties.

Disclosure required board report (sample reporting)

Particulars of Contracts or Arrangements with Related Parties

Under the Companies Act 2013, all contracts / arrangements / transactions entered into by the Company during the financial year ended.....with related parties were on an arm's length basis and were in the ordinary course of business. Moreover, none of the transaction were material in nature, and therefore, Members' approval was not required to be obtained, in accordance with the Policy of the Company on materiality of related party transactions. Thus, provisions of Sections 134(3)(h) and 188(1) of the Companies Act, 2013 and Rule 8(2) of the Companies (Accounts) Rules, 2014 are not applicable to the Company and therefore, **Form No. AOC-2** has not been attached.

In compliance with the requirements laid down in the SEBI (Listing Obligations And Disclosure Requirements) Regulations 2015 [SEBI (LODR)], all related party transactions were placed before the Audit Committee for approval. Prior omnibus approval of the Audit Committee had been obtained for transactions which were foreseeable and of repetitive nature. All transactions entered into with the related parties are presented to the Audit Committee by way of a statement giving details of all transactions.

THANK YOU!

KNOWLEDGE MANAGEMENT TEAM OF MEHTA & MEHTA

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