RPTs: Where India Inc stumbles

Abuse of related-party transactions continues to pose serious corporate governance challenges in the boardroom

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ILLUSTRATION: AJAY MOHANTY

A company with multiple successful brands and significant exports had an interesting disclosure as part of the company's financials. The general contractor of store construction for the company was owned by the chief executive officer's brother. In another instance, the chief executive officer of another listed company sponsored television programmes and art shows where his friends and relatives were the main beneficiaries.

The value of transactions with the potential for such conflicts, past examples of which are given above, exceeded ₹2.8 trillion in 2018-19 (FY19), based on 31 companies analysed from the S&P BSE 100 index. The latest figure is lower on a relative basis than past years, suggesting that instances such as those listed above haven't disappeared.

Both examples were mentioned as part of a background document hosted on the Organisation for Economic Cooperation and Development's (OECD's) website. The document authored by Pratip Kar talked about abusive related-party transactions and was presented as part of an event on global corporate governance held in 2010.

Regulatory changes since then have tightened scrutiny on such transactions. But controversies over such transactions at companies ranging from drugmaker Sun Pharmaceutical Industries to India's largest airline brand IndiGo suggest that the matter is far from resolved.

Among the reasons for this is the prevalence of large promoter-shareholders. Unscrupulous ones may use people over whom they have influence but don't fall under the related-party list to siphon off money from the company while avoiding scrutiny, according to Shriram Subramanian, founder and managing director of proxy advisory firm, InGovern Research Services. "If a small vendor for your company is owned by your driver then it is not a related-party transaction," he said.

The median value of such transactions on the profit and loss statement was at 7.8 per cent of net sales for the 31 companies mentioned above. The median value of deals declared as part of the balance sheet worked out to 1.6 per cent of total assets.

Meanwhile, there are still gaps between the Companies Act and the Sebi regulations which deal with listed companies.

Gaurav Pingle, Pune-based company secretary and author of the book *Decoding Related Party Transactions*, said the Companies Act sets a different tone than the Sebi regulations in some instances. For example, the Companies Act requires shareholders' approval for most related-party transactions. Exceptions include transactions under the ordinary course of business and deals done at an arm's length. The threshold for shareholder approval in listed companies is based on if the value of transactions exceeds 10 per cent of the annual consolidated turnover.

"There is no set parameter for identifying the ordinary course of business or arm's length valuation under the Sebi rules. Any difference in the regulation can create a gap for companies to pick and choose which standard to follow. Harmonisation between the Companies Act and Sebi's rules would help address any loopholes," he said.

Ankit Singhi, partner at advisory firm Corporate Professionals and company secretary, also said that there are loopholes which companies could exploit while trying to push through such transactions.

"It is explicitly stated that prior approval is required from the audit committee. However, since it is not explicitly said that shareholders' approval is also required before the transaction, many companies choose to go to shareholders after the transaction has already been completed. Also, requiring a special resolution rather than an ordinary resolution would call for wider participation from the shareholders in the approval process," he said.

A special resolution requires a two-third majority while an ordinary resolution only needs more than half the votes.

One solution could be that the company's board establish broad guidelines over and above the regulations. Shailesh Haribhakti, a chartered accountant and board member, suggested avoiding related-party deals unless the product or service is unavailable anywhere else and subjecting such transactions to an audit by an external agency. "Each organisation must define the ordinary course and arm's length for their special circumstances," he said.

Sai Venkateshwaran, partner and head, CFO Advisory, KPMG in India, said the 10 per cent threshold could be handled with more nuance.

"This...could be seen as a potentially high threshold in many situations. The materiality threshold should be modified to bring in other relevant ratios or hybrid thresholds," he said.

Meanwhile, increased disclosures have led to greater scrutiny from shareholders for all companies. This makes it harder for such transactions to be passed when put to vote. Activism by institutional shareholders has also picked up. Foreign and domestic institutional shareholders now account for 35.6 per cent of the total market capitalisation as of June 2019. They owned 27.5 per cent in June 2009.

Experts suggested other ways that the situation can be improved even as institutional shareholding rises. Harsh Pais, partner at Trilegal, suggested all related-party transactions, regardless the size or nature, be disclosed to serve as a check on improper transactions.

"Shareholders should refrain from providing omnibus approvals, which collapse the details of various RPTs into a single resolution. This smoke screening is a common practice, which the shareholders should be wary of," said Mithun V Thanks, partner, Shardul Amarchand Mangaldas & Co.

HOW TO IMPROVE

- Modify the 10 per cent threshold to include other relevant ratios
- Shareholders can avoid omnibus approvals
- Disclose all related-party transactions, irrespective of size
- Subject transactions to external audit
- Plug loopholes between the Sebi regulations and the Companies Act

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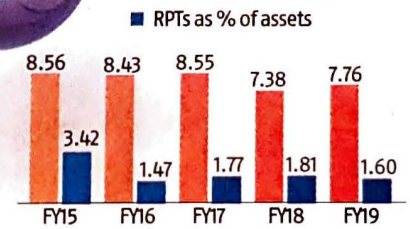

Note: Based on 31 companies from the S&P BSE 100 where annual reports have been released and with continuous data over the last five years Sources: Capitaline, *Business Standard* calculations