



FOUNDATION FOR AUDIT QUALITY

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# **Toolkit for assessing compliances pertaining to Related Party Transactions- *Foundational framework for implementation of RPT requirements***

**Foundation for Audit Quality**

July 2024

[www.faqonline.org](http://www.faqonline.org)

# Introduction

Effective corporate governance is essential to cultivate a company's culture of integrity and growth, and to gain investor confidence. One of the key elements of good corporate governance is a robust evaluation of transactions with related entities (Related Party Transactions or RPTs).

## Global context and the G20/OECD Principles of Corporate Governance<sup>1</sup>

Recognising that the purpose of corporate governance is to improve the legal, regulatory and institutional framework for corporate governance, with a view to supporting market confidence and integrity, economic efficiency, sustainable growth and financial stability, the OECD, working with the G20, has developed "The G20/OECD Principles of Corporate Governance" ("G20/OECD Principles").

The G20/OECD Principles are the main international benchmark for good corporate governance. Partnering with the G20 also means that the G20/OECD Principles have a global reach and reflect the experiences and ambitions of a wide variety of jurisdictions with varying legal systems and at different stages of development. They are also one of the Financial Stability Board's Key Standards for Sound Financial Systems.

The G20/OECD Principles also specifically deal with related party transactions.

Principle II-F and II-G, forming part of Chapter II – "The rights and equitable treatment of shareholders and key ownership functions" state:

*F. Related party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of a company and its shareholders.*

- 1. Conflicts of interest inherent in related party transactions should be addressed.*
- 2. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.*

*G. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited.*

Further, Sub-principle 7 of Principle V-D, forming part of Chapter V - "The responsibilities of the board" states:

*D. The board should fulfil certain key functions, including*

- 7. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.*

<sup>1</sup> OECD (2023), G20/OECD Principles of Corporate Governance 2023, OECD Publishing, Paris, <https://doi.org/10.1787/ed750b30-en>.

The G20/OECD Principles are accompanied by a commentary to help understand their rationale and also include descriptions of dominant or emerging trends and offer alternative implementation methods and examples that may be useful in making the G20/OECD Principles operational.

#### ***Regulatory environment in India around RPTs***

Most of the G20/OECD Principles relating to related party transactions have been enshrined in the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('SEBI LODR') in Chapter II - Principles Governing Disclosures and Obligations of Listed Entity. These core principles in the SEBI LODR have been supplemented by detailed regulations.

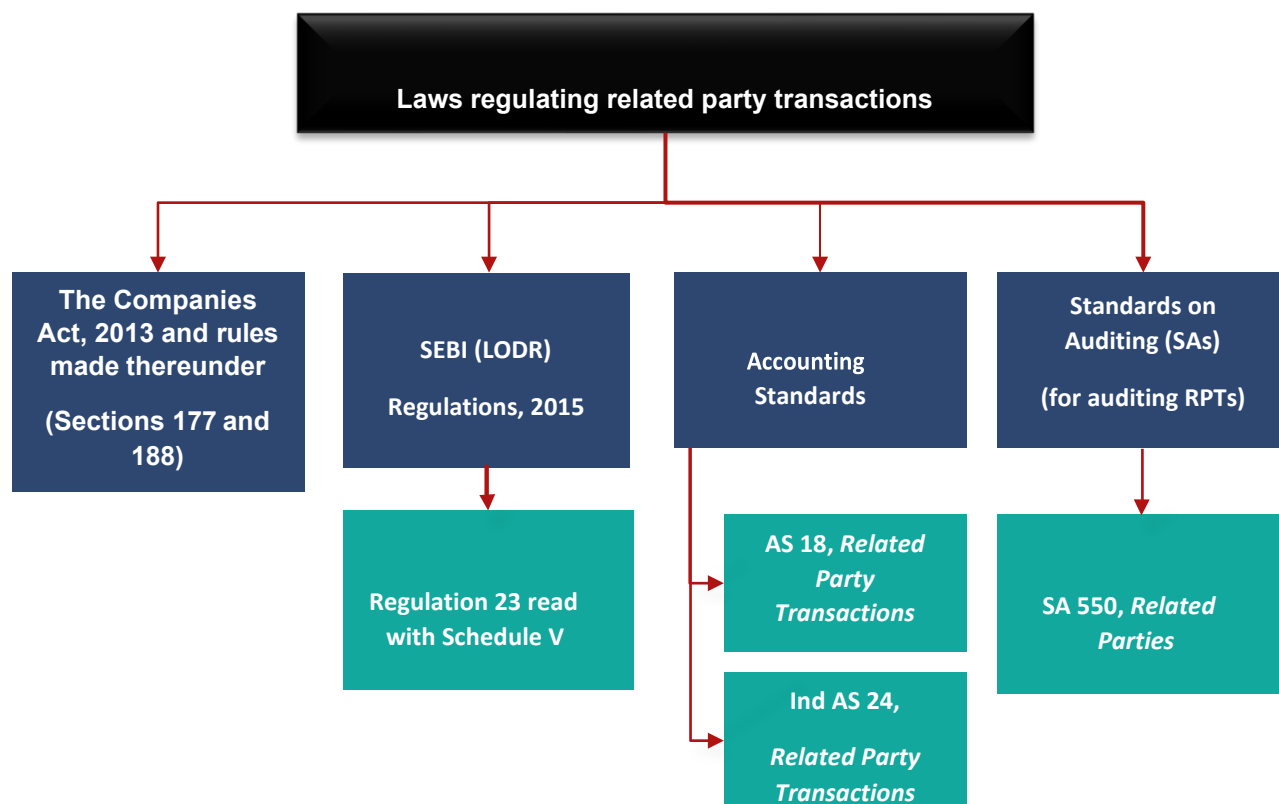
The G20/OECD Principles recognise that the potential abuse of related party transactions is an important policy issue in all markets, but particularly in those where corporate ownership is concentrated, and corporate groups prevail. Further, it also acknowledges that banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure.

It is in this context that the report of the working group on RPT highlighted that while it is recognised that RPTs can *per se* have sound economic rationale and can be value enhancing, there have been concerns about certain transactions being questionable or against the interest of minority shareholders or even bordering on fraud or ill-intent. There have also been cases observed where an entity has complied with the letter of the law, while ignoring its spirit. The prevalent use of complex group structures and subsidiaries for RPTs, particularly with unlisted entities, has increased concerns such as siphoning of funds, money laundering and round tripping.

RPTs have thus been a focus area for all regulators and policy makers, and there are various regulations governing the same. The Companies Act, 2013 and the Securities and Exchange Board of India (SEBI) have stipulated detailed procedures for approval of RPTs (as defined by the respective laws and regulations) - this includes obtaining the approval of the audit committee for all RPTs and of the shareholders in certain cases. The Accounting Standards (AS) and Indian Accounting Standards (Ind AS) have defined related parties and RPTs and require companies to disclose prescribed relationships and transactions with related parties in their financial statements to enhance transparency in this area. The Standards on Auditing (SA)<sup>2</sup> require auditors to perform stipulated procedures, such as adjusting the risk of material misstatement for components of financial statements which involve related party transactions, and include procedures, such as considering fraud risks, etc.

<sup>2</sup> SA 550, *Related Party Transactions*, deals with the audit procedures for transactions entered into by an entity with its related parties

**Figure 1: Laws regulating transactions with related parties**



*(Source: Foundation for Audit Quality's analysis, 2022 read with Guidance Note on Related Party Transactions issued by the Institute of Company Secretaries of India (ICSI), in March 2019)*

### ***Aligning the principles with practice***

For a large number of companies, many transactions with related parties are undertaken as they are essential or prudent from a business perspective.

Therefore, a framework that provides sufficient ease in entering into transactions with related parties that constructively augment the business should be encouraged, while having enough checks and balances to deter any abusive transactions. To ensure that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure, both, the Board of Directors as well as management in a company would need to step up their procedures and practices, for example:

- Advance planning of the RPTs would help achieving the compliance requirements of the LODR Regulations
- Procedures and practices relating to establishing the arm's length pricing or market terms for the transactions
- Accounting manuals at a group and components level need to be updated at regular intervals to provide clear guidelines regarding RPTs and document a mechanism for identification of related parties along with an approval process for RPTs

- The business rationale for the transactions and putting it through the necessary approval processes
- Sufficient information being made available to the approvers to make an informed decision, and
- Adequate and timely disclosures being made available to the relevant stakeholders.
- Automation of the related parties' information for the entire group.

### **Adopting a code of best practices for conducting RPTs**

In order to drive the Indian capital markets into a leadership position at a global level, the responsibility also lies with the companies, who are members of the capital markets. Companies would need to adopt the best corporate governance practices, and ensure good administration throughout the organisation, by adhering to ethical principles. With this broad objective, it would be ideal for companies to develop a code of best practices for conduct of RPTs, adoption of which would enhance investor confidence and protect stakeholders' interests.

### **Key tenets for developing a code of best practices for conducting RPTs<sup>3</sup>**

#### **Ethical business practices pertaining to RPTs**

Ethics is the essence of good governance and is exceptionally relevant when it relates to RPTs. Companies should adopt policies and procedures intended to ensure effective governance and achieve confidence of the investors in their business practices. Considering this objective, the code of best practices for conduct of RPTs should be built and following are key tenets:

- **Interests of all relevant parties:** Undertake transactions that are fair and protect the interests of all shareholders and stakeholders. Conversely, do not undertake any transactions that favour or benefit one set of shareholders / stakeholders to the detriment of other shareholders / stakeholders
- **Genuine business purposes:** Undertake transactions for genuine business purposes only.
- **Fair and equitable terms:** Undertake transactions on market terms (arm's length pricing and other commercial considerations). Transactions with related parties and with third parties should be treated on par in terms of assessments, approvals, pricing, payment terms, security, etc.
- **Transparency:** Ensure transparency on pricing, quantum, rationale, beneficiaries, etc.
- **Simplicity in transaction:** Undertake transactions using simple structures and terms. Conversely, avoid opaque transactions or structures.
- **Robust assessment and documentation:** Ensure assessment of RPTs is robust, holistic, and well documented, to enable key decision makers, including Audit Committee, Board of Directors or shareholders to take a well-informed decision.
- **Compliance with laws and regulations:** Comply with the approval mechanism stipulated by various regulations governing RPTs.
- **Adequate disclosure reporting:** All RPTs should be adequately disclosed as per the requirements of applicable regulatory and financial reporting frameworks.
- **Alignment of longer-term interests:** Engage with a related party, if there is a longer-term alignment on mutual value creation.

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<sup>3</sup> This section should be part of the 'Governance Charter' of the Board of Directors and related practice manuals including accounting manual of a company at a group and component level.

#### Guiding principles for evaluating an RPT

The OECD, in its 'Guide on Fighting Abusive Related Party Transactions in Asia' has recommended a six-step guide for analysing a RPT, the essence of which is reflected below. The audit committees and Board of Directors (BoD) may consider using relevant elements of this to augment their processes for evaluating RPTs:

WHO are the parties on either side of the transaction?	In few cases, two parties may initially appear unrelated. However, it is essential to unravel the complexities in the holding structure of the entities to understand how the transacting entities are related.
WHAT RESOURCE is being transferred?	The resource being transferred could be a capital asset, raw materials, services, loans, guarantees, etc. BoDs should seek a full understanding of the resources being transferred and their parameters, and the ownership interest of the related parties within the same.
HOW is the transaction priced?	BoDs should study the valuation report pertaining to the transaction and determine the methods adopted for valuation, or if the offer price meets the valuation. It should also be determined whether some discussion on how the price was agreed upon has been included in the related party agreement.
WHAT COMPENSATION is involved?	BoDs should determine the compensation involved in the transaction- i.e. would it be cash or an asset swap, such as transfer of shares in a third party. The reason for transfer of an asset should be inquired and determined.
ARE any of the parties conflicted?	Whilst the scope of conflicts of interest is broad, areas which may lead a party (generally directors or advisers to the transaction) to be conflicted include when the pecuniary interest of the party are in conflict with those of the company or when the professional judgement to act in the best interest of the company and its shareholders is compromised.
WHY is the resource being transferred or transaction being undertaken? Why now?	In many cases, timing of a transaction influences RPTs, for example, related parties have incurred losses on a separate entity or business venture, or at a personal level and may be keen to 'inject' assets into that entity to prevent a breach of debt covenants or to make good the loss.

(Source: Guide on Fighting Abusive Related Party Transactions in Asia, issued by OECD in September 2009)

# Foundational framework for implementation of RPT requirements

An ideal regulatory framework should provide a construct to deter undesirable RPTs while providing ease to genuine transactions. This will contribute to the growth of the business and the economy at large. As mentioned earlier, the Companies Act, 2013, the LODR Regulations and the accounting standards highlight various requirements with regard to identification of related parties, transactions with related parties, and disclosures thereof. The Companies Act, 2013 and the LODR Regulations also prescribe robust approval mechanisms for RPTs. In a nutshell, all these regulations lay down the principles for an enhanced corporate governance environment around RPTs.

Considering the disparate requirements in all these regulations, corporates need to incorporate appropriate systems and processes to ensure that these regulations are embraced in both the letter and spirit.

The SEBI revised the LODR Regulations with regard to related party norms, by including:

- A wider net of entities as related parties and a broader set of transactions as related party transactions;
- Enhanced the approval requirements of audit committee and shareholders; and,
- Enhanced the disclosure requirements to the audit committee, shareholders and to the regulators.

These amendments require companies to revisit their existing procedures on related parties and make amendments, wherever necessary.

This implementation toolkit, which is in the form of a checklist captures the RPT and compliances prescribed in all corporate reporting regulations which are applicable to corporates currently. We will update this checklist if the regulations undergo changes. The checklist aims to cover some practical considerations that would help overcome certain potential challenges that companies could face complying with the RPT norms (including the revised SEBI norms).

## Foundational framework for implementation of RPT requirements

Every company that is required to comply with the RPT requirements should lay down a foundational framework for the company and its subsidiaries (the group), which comprises of certain essential elements to enable an effective implementation of these new requirements. It is essential that the pre-requisites for identifying related parties and for entering into related party transactions are communicated by the listed entity to its entire group - in India and overseas. Accordingly, an RPT policy and framework for identification of related parties and RPTs and the compliance process (for example, the group related party policy and process manual, group accounting policy manual) should be defined at a group level and applied by all subsidiaries.



#### Essential elements of this foundational framework

There are certain key elements to implement the foundational framework for RPTs and include the following:

- 1. Periodic declarations from directors, promoters and KMP:** Companies should obtain a declaration at the start of the financial year and periodically from directors, promoters and KMP of the listed entity, its holding company and its subsidiaries, specifically for compliance with the SEBI LODR requirements. This will help to identify related entities of directors, promoters and KMP and members of the promoter group, who would also be considered as related parties of the group.
- 2. Approach for identifying indirect transactions (that benefit related parties):** The board of directors of companies should define certain criteria to identify indirect transactions, i.e., transactions with a third party, the purpose and effect of which is to benefit related parties. Management should lay down processes to identify transactions in line with the Board / Audit Committee determined criteria. This could be disclosed on the website of the listed company as part of the RPT policy of the company and its group. Certain confirmations from third parties with whom transactions are being entered into may also be obtained.
- 3. Management's compliance processes:** Companies should implement additional procedures to corroborate the information provided by the promoters/directors by performing additional processes, such as by evaluating the relationships of promoters, through directorships, investments, and so on, by accessing relevant portals / databases. Certain individuals, such as the Chief Financial Officer (CFO) or the Company Secretary (CS) of the company may be given responsibility to ensure compliance with all RPT regulations. For this purpose, the CFO or the CS may appoint internal or external agencies who could test transactions on a sample basis to check controls for compliance. Where non-compliances are observed, the compliance officers could point these out to the management and to the audit committee so that corrective actions are taken on a timely basis.  
  
Companies should also set up a second line of defense by either empowering an independent team or engaging with external agencies, which would help management ensure compliance with regulations and help companies to take corrective actions in case of any non-compliances.
- 4. Technology-enabled database of related parties (including automation for all sub-systems):** Related parties of the entire group should be maintained in a database of related parties, which should be updated on a periodic basis. A cost-effective solution should be adopted by companies, by performing a cost-benefit analysis. An example of a technology solution that may be adopted is, maintaining the related party database on a technology enabled platform which could provide trigger-based alerts every time a related party transaction is proposed to be entered into. Apart from obtaining declarations from directors, KMP and promoters providing details of their related parties which may be maintained on a technology enabled platform, this related party database may be linked to other database of the company, such as the customer or vendor master data, etc. so that trigger-based alerts are issued to the company when a transaction is planned or entered into with a related party.<sup>1</sup>

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<sup>1</sup> **Database of connected parties:** Regulators may consider preparing and sharing with companies a list of connected parties (i.e. a list of related parties and potential related parties) by identifying related parties as per

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### Foundational framework for implementation of RPT requirements

- 5. Advanced planning of RPTs:** RPTs may be required to be entered into for various purposes, including procurement, sale, services, leasing, etc. While planning for RPTs at the beginning of the year, a company will need to co-ordinate with all functions to determine which transactions would need to be entered into. Considering that a prior approval of the audit committee and shareholders is required for related parties of a listed entity and its unlisted subsidiaries, it is essential to have a cross-functional co-ordination and communication. This will help companies plan for the process of compliance for RPTs at a group level at the beginning of the year.
- 6. Audit committee's approvals:** With the independent directors on the Audit Committee being responsible for approval of all related party transactions, this becomes more challenging with the new requirements, including the wider net of related parties, and the broader set of related party transactions, and indirect transactions. In order to effectively play their role in implementing these changes, an Audit Committee should seek to lay down the policy framework as well as criteria and guidelines to be used by management in implementing these requirements. They should also define the checks and balances they would seek to have in place across the organization, including the information that they will seek to review periodically to get comfort that the requirements are being implemented appropriately. They should also lay down a suitable approach for management to present information to the Audit Committee, such as through logical bucketing of parties and transactions based on certain attributes (such as nature of transactions, materiality of transactions, pricing approach, etc.), shared for an Audit Committee's approval. This way information would help an audit committee provide appropriate level of attention.
- 7. Role of the subsidiaries:** Unlisted subsidiaries of listed holding companies also need to table certain RPTs<sup>2</sup> for the approval of the audit committee and/or shareholders of the listed companies and submit disclosure of their RPTs on a six-monthly basis<sup>3</sup>. Accordingly, it is essential there is a close co-ordination between the relevant teams of these subsidiaries and relevant teams of the listed companies so that RPTs and their approval may be planned in an efficient manner. Subsidiaries should also collate and submit to the listed holding company all disclosures in a timely manner, so that the listed company can make their six-monthly disclosures to SEBI within the prescribed timelines.

Companies should also plan for effective communication of the LODR regulations and their requirements with their overseas subsidiaries including Key Managerial Persons of these subsidiaries to ensure compliance with the regulations.

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the various regulations applicable to a company and its group and identifying certain individuals or entities with certain common linkages. This common linkage could include entities with common directors (current and past), entities having the same address, entities with same phone numbers, entities the directors/KMPs of which share the same residential address, etc. Maintenance of such a list could deter relevant people or entities from not making appropriate disclosures of their related parties.

<sup>2</sup> As per the Listing Regulation, a prior audit committee approval is required for RPTs to which the subsidiary of a listed entity is a party, but the listed entity is not a party, if the value of such transactions whether entered into individually or taken together with previous transactions during a financial year exceeds 10 per cent of the annual standalone turnover in accordance with the last audited financial statements of the subsidiary.

<sup>3</sup> This is because the listed company has to submit to SEBI on a six-monthly basis, a consolidated list of RPTs entered into during that period

#### Structure of this toolkit

The regulatory requirements and practical considerations have been classified within the four main areas, namely:

**A: Identification of related parties;**

**B: Identification of related party transactions;**

**C: RPT approval mechanism; and**

**D: Disclosure requirements of RPTs.**

#### Category of procedures

Within each topic, the checkpoints have been bifurcated into three sets of procedures - the base procedures, the management diligence procedures, and the monitoring procedures. These are further explained below.

- **Base procedures:** These include the basic procedures that each company may consider adopting in order to comply with the related party regulations.
- **Management diligence procedures:** The base procedures should be supplemented with management diligence procedures, which will enable management to have a maker checker control. Where the base controls will work as 'maker' controls and the management diligence procedures will work as 'checker' procedures.
- **Monitoring procedures:** For the monitoring procedures, the management may consider appointing an external or internal department (for example, an external agency that will oversee the implementation of the RPT framework, or an internal audit department) to oversee the functioning of the controls of the company.

#### Phased approach to implementation

We have strived to provide an exhaustive list of procedures that can be adopted by companies while they comply with the RPT framework (specifically the revised RPT framework prescribed by SEBI). Companies may consider adopting these procedures in a phased manner, by first adopting the procedures that are essential and then adopt other best practices<sup>4</sup>.

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<sup>4</sup> Other best practices have been written in turquoise font colour.

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