



Asia Roundtable on Corporate Governance

Fighting Abusive Related Party Transactions in Asia

Workshop on Implementation

BACKGROUND DOCUMENT

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Related Party Transactions and Effective Governance How it works in practice in India

Defining the issues

A transaction which could be a business deal, a single or series of financial contracts, or an arrangement between two parties who are joined by a special relationship prior to the transaction would be a related party transaction. The concerned parties on the two sides of the deal could be a parent company and its subsidiaries or affiliates, the employees, the principal owners, directors or management of the company and the subsidiaries, or members of their immediate families. This concept of related party transaction is now fairly well understood by Indian business. Indeed, there exists a body of laws, regulations, codes in place in India which directly or indirectly lay down the “do’s and don’ts” of related party transactions. For example, there are sections in the Indian Companies Act, 1956 such as 297, 299 and 314(1A) (which have been in place since the enactment of Act in 1956), the Companies Audit Report Order, section 44AB of the Income Tax Act, clauses 32, 41 and 49 of the Listing Agreement between the stock exchanges and the listed companies, which embody the concept a related party transaction, though none of these, save clause 49 of the listing agreement, have any explicit reference to the term, “related party transaction” . In a broad sense therefore a coherent regulatory system dealing with related party transactions, particularly in disclosure and board oversight, exists in India. The important issues for enquiry are the effectiveness of the system and its enforcement and how easily it can be bypassed. The paper looks at the related party transactions not from the point of view of what things should ideally be and done, but more from the situation is in this context that the instances of Indian comply with the the disclosure boards which of corporate measures often companies to and disguise the transactions as usual commercial decisions in the normal course of business. These instances are presented solely for the purpose of facilitating discussions on the subject of the paper.

The related party transactions give rise to situations of conflicts of interest and are integrally related to the overall governance of a company and to board’s effectiveness, as the board as the responsibility of direction and control of the company lies with the board of the company.

what should ideally be the point of view of what actual practice. It is in paper presents some companies who fully regulatory system, meet requirements and the maintain high standards governance, and several adopted by some circumvent the system related party

It is now well appreciated in India that a related party transaction can present a potential or actual conflict of interest and may not be consistent with the best interests of the company and its shareholders. It can lead to situations in which funds are tunnelled out of the company into another entity which is a “related party” or result in situations in which a business opportunity is lost to the detriment of the interests of the company and its shareholders. In that sense these situations of conflicts of interest become integrally related to the overall governance of a company and board’s effectiveness, as the board carries the burden of the responsibility of direction and control of the company.

But all related-party transactions are not illegal; at least most of them are not. Indeed there may be several such transactions which are unavoidable, as these often make tremendous commercial sense and if companies are prohibited from entering into such transactions, it might militate against the principle of maximising the shareholder value. Take for example a large automobile company A, a world class steel manufacturer S and a software giant T, all the three are known to have a common entity as the majority shareholder. If the company A determines that it would get the best deal in quality and price for steel from S and for the software for the car from T, and both S and T are offering their products only on commercial terms including discount, delivery schedule and competitive pricing, then it will be against commercial interest of A, not to procure these products from S and T merely because they have common ownership and hence be labelled as related party transactions. Law does not prohibit such transactions but puts in place checks and balances such as requirements of disclosure and statutory approval.

Adam Smith has observed that when other people’s money is involved, *“it cannot be expected that the managers would watch over it with the same anxious vigilance as they would watch over their own and [that] negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company”*. However, under certain conditions the transactions can allow controlling shareholders or executives of a company to benefit personally at the expense of non-controlling shareholders of the company. In such situations, there would be conflicts between the private interests of individuals and his duties to the company which could impair the integrity, independence and the quality of the decisions. Such conflicts would lead to compromising the company’s ability to enter into fair contracts. It could lead to boards taking strategic, financial or commercial decisions which weigh adversely on shareholder value. It has been seen that the costs of abusive transactions are high, because these would result in one-off or slow material expropriations of wealth, through continuous operational transactions.

Naturally the related party transactions would have to be managed in a transparent and legal manner so that these do not impose a heavy burden on the financial resources of a company, distort competition, affect optimum allocation of resources, waste public resources and lead to corrupt practices. Notwithstanding the presence of laws, rules and regulations in the Companies Act and in Clause 49 of the listing agreement, well governed companies, institute ways and means even beyond the existing laws to deal with related party transactions effectively.

Related party transactions are common to any business in any country and are not something unique to India or Asia and it would be misleading to state that such transactions are common to family owned businesses only. In the US, at one time, all related-party transactions had been banned, but that was seen as overly restrictive. The US SEC lifted its prohibition against such deals. In the aftermath of the accounting scandals the SEC addressed one of the plethora of ways that insiders can benefit themselves at shareholders' expense by debarring companies from making loans to management. It is known that generous and ultimately forgiven loans were a large part of the downfall of WorldCom and Adelphia. Rate Financials Inc. is an independent, privately-held, New York City based company, founded in 2002 by investment banking executives and research analysts. The company rates and ranks the financial reporting of the largest U.S. public companies – the S&P 500 and selected other public companies – based on the key SEC reporting requirements, such as 10-Ks, 10-Qs, 8-Ks, proxies. A 2004 study by the company found that 40% of all companies in the S&P 500 have some kind of related-party transaction.

Equally, there are instances of abusive related party transactions across the world in developed and emerging markets. One of the recurring themes in the cases of governance failures in companies like Enron, WorldCom, Adelphia, Tyco and Parmalat, was the cosy relationships between the management and directors of these companies and the business that they did. No doubt there was financial fraud in these companies; equally rampant at many of these companies was the abusive related party transactions. The deals were supposedly conducted at arm's length. But the investigation reports revealed that the transactions ultimately benefited several of the principals involved. Whether it was loans to directors, lucrative consulting contracts, or real estate deals involving executives, directors, or their family members, the point was the same: the companies were using shareholders' resources to favour insiders. In the 1980s in the days of the LBO boom, the abusive related transactions led to rampant insider trading in several of the investment banking firms on the Wall Street.

In June 2008, the American financier, private equity investor and corporate raider, Carl Icahn, launched The Icahn Report which campaigns for shareholder rights. In his report

he says that there exists symbiotic relationship between the Boards and the CEOs and in practice “there is no accountability”.

Since in India there exists an overarching regulatory framework with sections of the Companies Act, the CARO, the clause of the listing agreement, the Income Tax Act as its components, and since the potential for abuse of the related party transactions is known, this paper does not argue why abusive related party transactions need to be avoided, it does not make a case for what needs to be done, nor the way related party transactions are to be regulated. While the relevant regulatory issues have been woven into the waft and weft of the text, the focus of the paper is not so much what ought to be in place and what should the boards do and what should the regulators do, for all this is already known. Rather the emphasis is on what happens in practice and why does it happen so and hence what could be done. For example, despite all the checks and balances, the case of Satyam Computers Ltd demonstrated how none of the bulwarks worked in reality. Was it the failure of the board, was it a deliberate complicity between the management and the family of the owners who set up the company and had only per cent of the shares, or was it the complicity or the failure of the reputed auditing firm? These are some interesting questions for discussions.

Historical context for existence of large number of related party transactions

There are several factors which are relevant to any discussion on related party transactions in India and also the reason for a large number of such transactions. The number of family owned businesses is high in India. In a family owned and operated business, it is natural to expect that there will necessarily be closer ties. The desire and opportunity to use a known party will be greater. While there can be benefits to such arrangements, such as the level of trust involved when dealing with familiar people, the chance for that closeness to also become a problem grows, too. The line between using a familiar face and exploiting shareholders' resources for personal gain becomes very wide and very gray in family owned businesses.

There are also a large number of listed companies in India that are also subsidiaries of multinational corporations, consequential to the Foreign Exchange Regulations Act, 1977 which required the 100% subsidiaries of international companies to dilute to 40% or less. Post-1991 policies discouraged 100% subsidiaries of foreign companies in certain industries. These often necessitated a number of related party transactions between an overseas parent and its Indian subsidiary. Wholly Indian “groups” also began to have such transactions intra-se their group companies. Where a director happens to be a professional lawyer or accountant, the legal provisions also covered purchases of professional services from him or his firm. There could also be transactions with businesses belonging to directors or their relatives & partners. Some

related party transactions are for products or services whose prices have clear arm's length benchmarks in the form of sales to or purchases from independent third parties. Others, and there are quite a many such products or services, are not comparable to benchmarks in the marketplace, these being provided only within a closed group.

Cases of related party transactions in India

Satyam Computers Ltd (Now Mahindra Satyam)

No discussion on abusive related party transactions can begin without a reference to the case of Satyam Computers Ltd. (See Box 1)

On Tuesday 16th December, Satyam Computer Services Limited announced its audacious plan to acquire controlling interest in Maytas (Maytas is Satyam spelt in reverse) Infrastructure and Maytas Properties for US\$1.6 billion. The family of Ramalinga Raju had a large shareholding in these two Maytas companies. The deal was cleared by Satyam's stellar board of directors which had several reputed independent directors. The move was aimed at transferring over ₹60 billion of cash from Satyam's shareholders to the Raju family which defacto controlled Satyam (with only 8% shareholding) and Maytas companies (with a substantial shareholding).

This outraged the mutual funds and institutional investors in India, who threatened legal action. The deal was announced by Satyam after the Indian markets had closed on December 16, 2008, but Satyam's ADR crashed over 50% when it opened for trading in the US. In view of the outrage, the deal was cancelled next day. The share price still crashed 30% and continued to fall even after the deal was cancelled. On January 7, 2009 the Chairman of the company admitted that he had committed fraud in the company. On January 7, 2009, Ramalinga Raju admitted in a letter to the stock exchanges and SEBI, that he had falsified the books of Satyam. He and his brother and the MD and the CFO of Satyam resigned.

Ramalinga Raju stated in his letter that the balance sheet of Satyam was inflated with nonexistent cash balance of ₹ 3 billion, nonexistent accrued interest of ₹3.7 billion and understated liability of ₹12 billion on account of funds arranged by Ramalinga Raju and an overstated debtor position of ₹4.9 billion as against ₹26 billion reflected in the books He further admitted in the letter that "What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. It has attained unmanageable proportions as the size of company operations grew significantly. The aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with real ones.

Thus on January 7, 2009 what was earlier a matter of suspected abusive related party transaction, indeed turned to be so, besides becoming a case of accounting fraud. Several regulatory actions followed in sequence – which led to the imprisonment of Ramalinga Raju (since released on bail), his brother and the senior officials of the company, reconstitution of the board of the company, action against the auditors Price Water House and the subsequent takeover of the company by Tech Mahindra and. The investigations are yet to be finally completed and final regulatory actions are pending in the case.

From the point of view of abusive related party transactions the case raises several questions (See Box 1).

- The role of the board and the management
- The role of the auditor – PriceWaterHouse
- The role of the Chairman, CEO and CFO and the senior officials
- The effectiveness of the regulatory requirements

The role of the board and the management: It was indeed difficult to accept that the Board had accepted the justification that buying large infrastructure companies in an economic recession was good for Satyam and its shareholders. But the Board instead remained focussed only on the fair valuation of Maytas. Since the two Maytas companies were primarily asset-based companies with land, structures, cash and some contracts, the Board

Box 1

Satyam Computers Ltd –

Issues in abusive related party transactions

- Discussion points

The role of the board and the management: Why did a well constituted board with a maximum number of reputed directors ignore that the transactions would amount to money being transferred from a publicly held company to a family.

The role of the auditor – PriceWaterHouse: The auditor was an internationally reputed firm; it was not that they were oblivious to the requirements under Clause 49 and the CARO report. Then why did the auditors not meet the obligations.

The role of the Chairman, CEO and CFO and the senior officials: The Chairman admitted to the falsification of the accounts and why he was trying to conclude the transaction between Satyam and the Maytas companies. Could he have done it without the complicity of the senior management?

The effectiveness of the regulatory requirements: Identical questions would arise for any case of corporate governance failure in India or in any other market. Is it because of lack of knowledge of the benefits of avoiding abusive practices and do mother hood statements help. How can things change or made to change?

Clause 49 currently requires CEOs/CFOs to certify that they have disclosed to the auditors as well as the Audit Committee, instances of significant fraud, if any, that involves management or employees having a significant role in the company’s internal control systems. The question is what happens in case there is a false certification by the CEO/CFO? Who checks it – does the responsibility lie with the auditor?

went by asset values. The minutes of the board meeting, which appeared in the public domain, showed that the board was only concerned with two aspects – following the regulations (SEBI and Companies Act matters) and valuation. The aspect of money being transferred from a publicly held company to a family did not seem to have come up for the consideration of the Board. It was not that the board was well structured and did not have a majority of internationally reputed independent directors who were unaware of their role; it was not that there was dearth of regulatory and disclosure requirements, and yet why did the fraud happen.

The role of the auditor – PriceWaterHouse: The auditor was an internationally reputed firm; it was not that they were oblivious to the requirements under Clause 49 and the Companies Auditor's Report Order (CARO).

But yet the auditor was oblivious to the regulatory obligations and certified the false accounts for a number of years.

The role of the Chairman, CEO and CFO and the senior officials: The Chairman admitted to the falsification of the accounts and why he was trying to conclude the transaction between Satyam and the Maytas companies. Was he oblivious to what he was doing and could he have done that without the complicity of the senior management?

The effectiveness of the regulatory requirements: There were prevailing requirements under the Companies Act and other pieces of legislation to prevent abusive practices. But what happens if all the parties involved deliberately do not comply? Then “what should be done” becomes a “motherhood statement” only. These questions are similar to questions which arise for any case of corporate governance failure in India or elsewhere – be it Enron, Parmalat, Drexel Burnham Lambert, or Maxwell Communications, or Micro Strategy to name a few.

Case of XYZ Corporation Ltd:

XYZ Corporation Ltd is a well known company who owns several popular brands. These brands also have a large export market too. The general contractor of the company store construction is owned by the brother of the company's CEO. This has been disclosed in the balance sheet of the company. The question is that despite the disclosure to public, save the transaction from being classified as an abusive related party transaction, and does this case and similar such instances introduce a potential for conflicts of interest (Box 2)

The Case of MXZ Ltd:

The MXZ Ltd is a profitable listed company in India. It had floated a subsidiary A several years ago for providing critical support infrastructure to the parent company. The company A was later bought out by a relation of the principal shareholder, at a very cheap price through a web of unlisted companies owned indirectly by the relative. The transactions of the parent company with the company A is disclosed in the balance sheet of the parent company. The senior executives of MXZ Ltd are directors of A. That

Box 2

Case of XYZ Corporation Ltd and the Case of MXZ Ltd.

- Discussion points

If there is a related party transaction and follows the disclosure norms stated in Clause 49 does a transaction cease to be potentially abusive or cease to have the potential for conflicts of interest. If that is so, what needs to be done in terms of the existing regulatory framework? What about the loss to the investors of MCZ Ltd when the company A was made independent of the parent company by -

Clause 49 currently requires that

- the Audit Committee reviews with management related party transaction. The meaning of the term "related party" has been made harmonious with the meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India; the records of related party transactions mandatorily reviewed by the Audit Committee;
- a statement of all transactions with related parties including their basis to be placed before the Audit Committee for formal approval/ratification;
- if any transaction is not on an arm's length basis, management shall provide an explanation to the Audit Committee justifying the same.

The points for discussion are: Are the transactions in the two cases cease to be abusive merely because there has been adequate disclosures. The regulatory requirements make the correct prescriptions, but what if these are not followed? What happens if the board does not apply its mind? How could the independent directors made to ask the right questions? Who should shoulder the responsibility?

there has been a takeover of A - the subsidiary of MXZ Ltd. by the relation of the principal shareholder is also now well known. But today the value of the company A has multiplied several folds enhancing the wealth of family. Is this a loss to MXZ Ltd.? Is mere disclosure in the balance sheet about the contracts entered into by MXZ Ltd with A makes the transactions less abusive? Since there is no record publicly available to suggest that the shareholders have not protested are the transaction between MXZ Ltd. and A, does it imply that the transaction not abusive? (Box 2)

Case of a CEO of a listed company:

A CEO of a company was asked to resign from the company. The allegations were that for several years-

- he favoured his friends corporate friends at the expense of the company by spending for parties for his and showed the expenses were on account of sales promotion;

- he fudged the events to claim compensation for fictitious conferences like distributors' conferences
- he claimed reimbursement was claimed on expenses of his daughter and wife
- he sponsored programmes on TV channels and art shows in different studios and hotels which his friends and relations were the main beneficiaries

Commonly used artifices to avoid easy detection of related party transactions

In India, Sections 297, 299 and 314(1A) of the Companies Act prescribe the levels of approval (boards of directors or Central Government) needed to do certain types of transactions with certain types of Related Parties. These provisions have existed in the law since 1956, with a number of subsequent amendments. Section 297 for example says that a company with a paid up capital of paid-up share capital of ₹10 million and above, would require the previous approval of the Central Government to enter into contracts for the purchase of goods and services in which a particular director, his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director is interested. This is an all encompassing clause and should be good enough to prevent abusive practices of related party transactions. Certain exceptions have been carved out to allow trade in the normal course of business to continue. Section 299 requires the disclosure of interest by a director in a Board meeting in case the director is interested in any contract which the company is proposing to enter into. Similarly Clause 49 imposes several disclosure requirements and casts a responsibility on the audit committee and the Board of the company (See Box 1 and Box 2).

1) Despite these requirements, the related party disclosures reveal that companies have been quite liberal with loans to subsidiary companies, joint ventures and "associates" (entities over which the company or its directors have significant influence). To obtain the approvals of the Central Government is not always easy, so what do the companies usually do? The commonest ploy is to disguise the transactions and cover the tracks to obfuscate the audit trail. Some common examples are given below:

- i. If a company A proposes to enter into a contract with another company B in which there is a common director, the common director resigns from the Board of B and then the contract between A and B does not appear to be a related party contract. Thereafter the director is re-inducted to the board of B
- ii. If a company A wants to enter into a contract with another company B in which there is a common director or a director and his relative or associate has a pecuniary interest, a third entity C is introduced in which the common director or his relative or associate, or partner has any apparent interest and A then enters into a contract with C, and C separately enters into one or more counter

contract with B. Since A and C and C and A are not related parties, the deal does not fall within the purview of related party transaction.

iii. Interlocking shareholdings in companies help to obfuscate audit trail. If three companies A, B and C are formed in a way that each owns 50% of each other, then none of the companies become wholly owned subsidiaries and yet the ownership is interlocked between the three companies. A company XYZ which has no apparent connection between A, B and C can enter into any contract with XYZ and all that XYZ needs to do is to have its own trusted people on the boards of A, B and C. After the transactions are over the ownership is changed.

- 2) It appears to be common practice for multinational corporations to source a significant portion of their raw material requirements from companies under the control of the same parent. In the absence of disclosures about the price and other terms at which such sale/purchase transactions are executed, it is difficult to judge whether the terms are unduly favourable to the group companies.
- 3) Quite a few related party transactions have taken the form of "expenses" reimbursed to group companies or enterprises controlled by the top management, though there appears to be no apparent connection.
- 4) Companies often get their researches conducted by their group companies and the companies might contribute significantly to such research.
- 5) Companies create multiple related party entities with promoters as key investors and transact with the company as mentioned in the another example above

Some of the reasons for companies in India to resort to unethical practices on related party transactions in India

The laws and regulations and accounting standards lay down fairly stringent requirements to prevent abuse of related party transactions; but there are good many reasons why it is not easy to legally identify a related party transaction. To understand the reasons, it is important to understand the related party transactions from the perspective of the companies.

1. Most companies and boards believe that related party transactions, even if these are justified, and disclosed, would generally be viewed with a negative connotation, because there is a presumption that the transaction will not necessarily be reported or completed on an arm's length basis and hence not strictly commercial. What follows from this premise is that there is a tendency not to disclose a related party

transaction or attempt to structure it in a way to avoid reporting under Companies Act, or Clause 49 or Accounting Standard AS18.

2. There is also a perception of nepotism about related party transactions and even if the transaction is genuine and done only on commercial terms, there is a hesitation to disclose this transaction. For example a director may hesitate to disclose a transaction done with a entity in which his relative is interested even if that entity have quoted the best possible rates and has the best possible expertise. The company would rather adopt questionable means and cover the tracks to avoid detection.

3. Another reason which leads the companies to have a degree of opacity about related party transactions is the accounting effect. The consolidated results of a company having subsidiaries are bound to be different from the stand alone results. For example, in a consolidated balance sheet, the sales to and from the subsidiaries to the parent will be eliminated and likewise the purchases which in turn will have a bearing on the profitability. If an infrastructure company sets up for power plant, in a standalone balance sheet it will show as a construction activity of the company but the treatment in a consolidated balance sheet will be different. Consolidation can help show a profit or a loss as expense or a reduction of expense depending on the situation. Consolidation can make profits disappear from balance sheet and structuring SPVs can help profits reappear. A company may choose to use the route benefits the company the most by suitably structuring the company so that it does not appear to be a subsidiary. To avoid the impact of consolidation on the balance sheet and Profit and Loss account, a company may chose to interpose an apparently unconnected entity so that all transactions look like being executed at arm's length. There are various simple and complicated ways of ensuring that an entity is seemingly unconnected.

4. Companies often use a number of SPVs to facilitate raising debt and not let the debt impact the balance sheet. But SPVs can also be used to hide losses on the balance sheet of the parent. To avoid detection in a consolidated balance sheet, the companies structure the SPVs as unconnected entities. These entities are controlled by trusted people of the company or the CEO or the Chairman. A variation of this method is to make the employees, household staff, drivers hold shares or appoint them as independent directors. Since the SPVs become unconnected entities under any legal definition, the question of consolidation will not arise, and these will remain outside the purview of any statutory audit.

5. There are restrictions by the Reserve Bank of India on the maximum lending exposure limits of banks to a single entity or aggregate limits of bank to a business

group. For the non banking finance companies also such restrictions exist. Companies and non banking finance companies structure entities and transactions to avoid these restrictions.

6. Another driver for avoiding reporting of related party transactions is avoidance of restrictions imposed by the Companies Act for inter company loans. Companies are known to set up entities which will be outside the pale of the legal classification of "related parties". For companies with international subsidiaries, transfer pricing is another reason why they resort to "covering the tracks" by setting up apparently unconnected entities.
7. Companies often set up a web of companies often with the same address in international jurisdictions which are tax havens and which have relaxed or little regulations on capital market to avoid detection of money trail and to facilitate

Box : 3 *Similar examples elsewhere¹*

Examples of related party transactions similar to the ones given in the text are found in some of the companies listed on the NYSE and NASDAQ demonstrating that the issue of abusive related party transactions are common to most markets. The way these transactions are executed often makes it difficult for the ordinary investors to detect the true nature of the transaction, especially when there is a boiler plate stating that the deals were arm's-length, approved by "disinterested" members of the board of directors. Proxy statements for the listed companies in NYSE and NASDAQ report numerous related-party transactions over the years, including loans and consulting-services payments to and from directors and management.

For example, the general contractor for **Gap** (NYSE: GPS) store construction is owned by the brother of the company's chairman. It's not illegal, but it introduces a potential for conflicts of interest. As the web site Motely Fool.com notes "large corporations aren't the only ones engaging in these types of deals. It may be prevalent in smaller businesses, since they're generally less covered by analysts. What should investors in Aaron Rents (NYSE: RNT) think about the company spending \$890,000 last year so that the company president's two sons could become race-car drivers? Or that the firm will be spending as much as \$1 million to that end this year"?

"Sometimes, related-party transactions aren't quite so over-the-top; they often have a seemingly legitimate business relationship. Wireless network developer Wireless Facilities (Nasdaq: WFII) announced it was withdrawing from the Mexican market and selling its subsidiaries there. Yet the company they were selling to was a new business created by one of the founders and former CEOs of Wireless Facilities, who would be receiving \$18 million. And the subsidiaries were run by another brother of the company founders. Again, there is nothing to suggest that these transactions were anything but aboveboard. Yet they introduce an air of favouritism, not to mention the suspicion of conflicts of interest.

money laundering. The companies establish several layers of subsidiaries so that the chain of transactions could be obfuscated. Companies ask their employees to hold the shares or open accounts with depository participants using different names and false addresses or different addresses. Unless there are investigations by regulatory authorities, these subterfuges cannot be easily detected and when there are thousands of companies, it is not practically possible for regulatory authorities to launch investigations easily. Similar examples exist in other markets too (See Box 3).

Good practices in related party transactions followed by companies in India

Just as there are cases of companies which adopt measures to avoid disclosure of related party transactions, there are companies who comply with the legal and regulatory requirements in letter and spirit (Box 4).

In such companies the boards play an important role in determining the policy on related party transactions and in monitoring the implementation of the policy through supervision. The boards insist that the important items of related party transactions are brought before the boards. As the Audit Committee is primarily responsible for approving the related party transactions it institutes systems and processes such that all significant related party transactions get reported and specifically approved by the Audit Committee.

Instances of practices followed by some companies in India are:

1. Board sets the clear direction and culture on all related party transactions.
2. Mandatory review by the board of

Box 4: Good practices in related party transactions followed by companies in India

Boards play an important role in determining the policy on related party transactions and in monitoring the implementation of the policy -

1. Board sets the clear direction and culture on all related party transactions.
2. Board mandatory reviews related party transactions exceeding 1% of revenue.
3. The audit committee reviews all material related party transactions.
4. Systems, processes, procedures are in place to avoid related party transactions becoming abusive.
5. The employees communicated a strong employee ethics policy that related party transactions are strongly discouraged.
6. Directors/Commissioners/Controlling shareholders are made personally liable for company loss if they exploit the company for personal interests.
7. Companies are required to develop and make public the policy and procedure for the approval of the related party transactions.
8. The financials of all subsidiaries and related entities are published on the web so that the shareholders can get a clear picture on the need and the related party transactions.
9. Every year, insiders who are responsible for decision in the company, are required to make statements that they do not have any conflict of interest in all decisions they make and they comply with the code of conduct of the company.

related party transactions exceeding 1% of revenue.

3. Review by the audit committee of all material related party transactions. This is in sharp contrast to a very common practice followed by companies which follow box-ticking compliance standards to keep a register of related party transactions open for inspection, without actually inspecting it.
4. Audit committee insists and checks that the financial aspect of the related party transactions disclosures is appropriate and detailed.
5. Board ensures that there are processes to monitor and evaluate all related party transactions.

These companies have put in place systems, processes, procedures to avoid related party transactions becoming abusive. Some of these are:

1. Communicating to the employees a strong employee ethics policy that related party transactions are strongly discouraged. All the vendors and service providers are required to declare their conflicts, if any, before they are empanelled by the company.
2. Establishing robust channels of verification of each transaction by creating a creator and approver concept, so that even if the related party transaction is initiated, the approver would not be a related party.
3. Insisting on specific pre-clearance taken from the Audit Committee for significant group transactions.
4. Boards mandatorily clearing related party transactions exceeding 1% of revenue.
5. Publishing the financials of all subsidiaries and related entities on the web so that the shareholders can get a clear picture on the need and the related party transactions.

Some practices followed by companies in India to ensure independent judgment to enhance in the decision making process:

1. Directors/Commissioners/Controlling shareholders are made personally liable for company loss if they exploit the company for personal interests.
2. Companies are required to develop and make public the policy and procedure for the approval of the related party transactions.
3. Every year, insiders who are responsible for decision in the company, are required to make statements that they do not have any conflict of interest in all decisions they make and they comply with the code of conduct of the company.

Summing up

Any discussion on related party transactions will have to take note of the circumstances and the ground realities prevailing in India which force companies not to disclose such transactions. These circumstances are the “raison de etre” for avoiding detection of related party transactions. The points for discussion are:

- a) Is the incidence of such avoidance high in India? While there is no statistical evidence to prove it, but discussions with auditors, lawyers and even company executives would suggest that it is high? But this would beg the question if this is the case in other markets too? That would be difficult to say. It may not be appropriate to judge only by the extent of disclosures, as the depth of the iceberg cannot be judged by the extent of the tip which is visible. The scandals in corporate governance and some of the cases of financial frauds in the developed markets would show the extent of related party transactions.
- b) It is clear that there are enough laws and regulations in India against abusive related party transactions. It is also not that company executives need to be advised on the harmful effects abuses of related party transactions. So such statements and discussions on why one needs to avoid abusive practices would seem to be like motherhood statements. Indeed the primary reason for avoiding disclosure of the related party transactions by companies stem not from ignorance of the laws and the absence of regulations but precisely from an understanding of these, which helps the companies to structure deals in a manner to avoid detections. Under these circumstances what is that needs to be done?
- c) Ultimately the vested interest of directors and the overwhelming influence of promoters of the company who treat company as their own significantly influence the company's policy on related party transactions.
- d) At the same time it is equally true there are a large number of companies which make elaborate disclosures about the related party transactions; the companies have explicit policy for disclosure of related party transactions which are disclosed on the web sites of companies. These companies are good, profitable companies; they are loved and respected by the investors. What is it that drives the individual companies to follow such a path? Is it at the end of the day, the philosophy of the company and its ethical values which matter which drives compliance culture in a company?
- e) Most financial frauds have their genesis in related party transactions. As has been seen what is relevant is that it is not the spirit of the transaction which matter, but whether the transaction falls under the purview of the legal definition of related party transactions. If it does not, then the accounting standards do not apply and the question of disclosure does not arise. It is precisely for this reason that it is difficult to make case studies on related party transactions, till the abusive practices blow up on the face like it did in the case of Satyam Computers Ltd. How could such situation be dealt with?
- f) Is dependence on the leadership role of the board the most important factor to drive the articulate philosophy of corporate governance in a company because fairness and transparency in related party transactions is one of the keys to sustainable corporate

governance? The role of the independent directors is important for board governance and they can force the companies to be transparent in the related party transactions in the company? But what if the independent directors fail to play the role effectively for whatever reasons? The case of Satyam Computers and other instances cited in the paper are good examples of failure of the independent directors to play the effective role.

- g) How important are the auditors and their ability to ask the right questions? In case the companies disguise the related party transactions using the subterfuges described in this paper can the auditors lift the veil and uncover the trail? We have seen that in many cases of corporate governance failures and financial frauds there has been a complicity of the auditors.
- h) Sustainable capitalism and sustainable corporate governance depend on the leadership which the boards provide to companies. The company must believe that

Discussion points

- Several circumstances form “raison de etre” for companies to structure transactions to avoid detection as related party transactions.
- It is not so much the ignorance about the related party transactions that compel companies to avoid disclosures of related party transactions.
- The genesis of most cases of financial frauds in any market is the related party transactions.
- There is no dearth of laws and regulations in India against abusive related party transactions. It is not the ignorance of the laws and regulations but an understanding of these, which helps the companies to structure deals in a manner to avoid detections.
- What drives some companies to follow the disclosure norms and others to avoid them?
- More than the spirit of the transaction, whether the transaction falls under the purview of the legal definition of related party transactions is relevant. If it does not, then the accounting standards do not apply and the question of disclosure does not arise.
- It is precisely for this reason that it is difficult to make case studies on related party transactions, till the abusive practices blow up on the face like it did in the case of Satyam Computers Ltd. How could such situation be dealt with?
- The role of the independent directors is important for board governance and they can force the companies to be transparent in the related party transactions in the company? But what if the independent directors fail to play the role effectively for whatever reasons?
- How important are the auditors to unearthing related party transactions? Can they help lift the veil and uncover the trail? We have seen that in many cases of corporate governance failures and financial frauds there has been a complicity of the auditors.
- Ultimately the vested interest of directors, the overwhelming influence of promoters of the company who treat company as their own and their unethical practices significantly influence the company’s policy on related party transactions
- When the C-suite fails in a company, there is not much to be done as cases of Satyam and other corporate governance failures have demonstrated.
- Sustainable capitalism and sustainable corporate governance depend on the leadership which the boards provide to companies. But the company must believe that business thrive and become long term sustainable prepositions only when there is truthfulness, honesty, vigilance must govern the driving philosophy of the company.

business thrive and become long term sustainable propositions only when there is truthfulness, honesty, vigilance must govern the driving philosophy of the company. Abusive practices provide only short term impulses to business growth.

ANNEX

Examples of companies which maintain high standards of corporate governance

Tata Steel Ltd. and Infosys Technologies Ltd (Excerpts from the Annual Reports 2009-10)

The following are excerpts from the Annual Reports of the Tata Steel Group and Infosys Technologies Ltd. for the financial year 2009-10. It highlights the corporate governance philosophy of the TATA group and the Infosys and the extent of disclosures made by the companies in respect of the related party transactions and pecuniary interests of the directors and employees of the group.

Tata Steel Ltd.

The Company's Corporate Governance Philosophy

The Company has set itself the objective of expanding its capacities and becoming globally competitive in its business. As a part of its growth strategy, the Company believes in adopting the 'best practices' that are followed in the area of Corporate Governance across various geographies. The Company emphasises the need for full transparency and accountability in all its transactions, in order to protect the interests of its stakeholders. The Board considers itself as a Trustee of its Shareholders and acknowledges its responsibilities towards them for creation and safeguarding their wealth.

In accordance with the Tata Steel Group Vision, Tata Steel Group ('the Group') aspires to be the global steel industry benchmark for value creation and corporate citizenship. The Group expects to realise its Vision by taking such actions as may be necessary in order to achieve its goals of value creation, safety, environment and people.....

Corporate Governance

The Company has a non-executive Chairman and the number of Independent Directors is 50% of the total number of Directors. As on 31st March, 2010, the Company has 12 Directors on its Board, of which 6 Directors are independent. The number of Non-Executive Directors (NEDs) is more than 50% of the total number of Directors. The Company is in compliance with the Clause 49 of the listing Agreement pertaining to compositions of directors.

None of the Directors on the Board is a Member on more than 10 Committees and Chairman of more than 5 Committees (as specified in Clause 49), across all the companies in which he is a Director. The necessary disclosures regarding Committee positions have been made by the Directors.....

The Board periodically reviews compliance reports of all laws applicable to the Company. Steps are taken by the Company to rectify instances of non-compliance, if any.

During 2009-10, the Company did not have any material pecuniary relationship or transactions with Non-Executive Directors, other than Dr. J. J. Irani and Mr. B. Muthuraman to whom the Company paid retiring benefits aggregating to Rs. 36.28 lakh and Rs. 318.93 lakh, respectively.

The Company has adopted the Tata Code of Conduct for Executive Directors, Senior Management Personnel and other Executives of the Company.

The Company has received confirmations from the Managing Director as well as Senior Management Personnel regarding compliance of the Code during the year under review. It has also adopted the Tata Code of Conduct for Non-Executive Directors of the Company.

The Company has received confirmations from the Non-Executive Directors regarding compliance of the Code for the year under review. Both the Codes are posted on the website of the Company.

Audit Committee

The Company had constituted an Audit Committee in the year 1986. The scope of the activities of the Audit Committee is as set out in Clause 49 of the Listing Agreements with the Stock Exchanges read with Section 292A of the Companies Act, 1956. The terms of reference of the Audit Committee are broadly as follows:

- a. To review compliance with internal control systems;
- b. To review the findings of the Internal Auditor relating to various functions of the Company;
- c. To hold periodic discussions with the Statutory Auditors and Internal Auditors of the Company concerning the accounts of the Company, internal control systems, scope of audit and observations of the Auditors/Internal Auditors;
- d. To review the quarterly, half-yearly and annual financial results of the Company before submission to the Board;
- e. To make recommendations to the Board on any matter relating to the financial management of the Company, including Statutory & Internal Audit Reports;
- f. Recommending the appointment of statutory auditors and branch auditors and fixation of their remuneration.

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Whistle Blower Policy

The Audit Committee at its meeting held on 25th October, 2005, approved framing of a Whistle Blower Policy that provides a formal mechanism for all employees of the Company to approach the Ethics Counsellor/Chairman of the Audit Committee of the Company and make protective disclosures about the unethical behaviour, actual or suspected fraud or violation of the Company's Code of Conduct. The Whistle Blower Policy is an extension of the Tata Code of Conduct, which requires every employee to promptly report to the Management any actual or possible violation of the Code or an event he becomes aware of that could affect the business or reputation of the Company. The disclosures reported are addressed in the manner and within the time frames prescribed in the Policy. Under the Policy, each employee of the Company has an assured access to the Ethics Counsellor/Chairman of the Audit Committee.

Ethics and Compliance Committee

In accordance with the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, as amended (the Regulations), the Board of Directors of the Company adopted the revised Tata Code of Conduct for Prevention of Insider Trading and the Code of Corporate Disclosure Practices (the Code) to be followed by Directors, Officers and other Employees. The Code is based on the principle that Directors, Officers and Employees of a Tata Company owe a fiduciary duty to, among others, the shareholders of the Company to place the interest of the shareholders above their own and conduct their personal securities transactions in a manner that does not create any conflict of interest situation. The Code also seeks to ensure timely and adequate disclosure of Price Sensitive Information to the investor community by the Company to enable them to take informed investment decisions with regard to the Company's securities.....

Disclosures

The Board has received disclosures from key managerial personnel relating to material, financial and commercial transactions where they and/or their relatives have personal interest. There are no materially significant related party transactions which have potential conflict with the interest of the Company at large.

The Company has complied with the requirements of the Stock Exchanges, SEBI and other statutory authorities on all matters relating to capital markets during the last three years. No penalties or strictures have been imposed on the Company by the Stock Exchanges, SEBI or other statutory authorities relating to the above.

The Company has adopted a Whistle Blower Policy and has established the necessary mechanism in line with Clause 7 of the Annexure 1D to Clause 49 of the Listing Agreement with the Stock Exchanges, for employees to report concerns about unethical behaviour. No personnel has been denied access to the Ethics Counsellor/Chairman of the Audit Committee.....

Tata Code of Conduct

All Tata Companies including the employees, members of the boards and other committees are required to adhere to a Tata Code of Conduct and clause 20 of the Code deals with the subject of conflict of interest. The issue of related party transaction is a part of this clause.

Clause: 20

Tata Code of Conduct - Conflict of interest

“An employee or director of a Tata company shall always act in the interest of the company, and ensure that any business or personal association which he / she may have does not involve a conflict of interest with the operations of the company and his / her role therein. An employee, including the executive director (other than independent director) of a Tata company, shall not accept a position of responsibility in any other non-Tata company or not-for-profit organisation without specific sanction.

The above shall not apply to (whether for remuneration or otherwise):

- a) Nominations to the boards of Tata companies, joint ventures or associate companies.
- b) Memberships / positions of responsibility in educational / professional bodies, wherein such association will benefit the employee / Tata Company.
- c) Nominations / memberships in government committees / bodies or organisations.
- d) Exceptional circumstances, as determined by the competent authority.

Competent authority, in the case of all employees, shall be the chief executive, who in turn shall report such exceptional cases to the board of directors on a quarterly basis. In case of the chief executive and executive directors, the Group Corporate Centre shall be the competent authority.

An employee or a director of a Tata company shall not engage in any business, relationship or activity which might conflict with the interest of his / her company or the Tata group.

A conflict of interest, actual or potential, may arise where, directly or indirectly if

- a) An employee of a Tata company engages in a business, relationship or activity with anyone who is party to a transaction with his / her company.
- b) An employee is in a position to derive an improper benefit, personally or to any of his / her relatives, by making or influencing decisions relating to any transaction.
- c) An independent judgement of the company's or group's best interest cannot be exercised.
- d) The main areas of such actual or potential conflicts of interest shall include the following:
- e) An employee or a full-time director of a Tata company conducting business on behalf of his / her company or being in a position to influence a decision with regard to his / her company's business with a supplier or customer where his / her relative is a principal officer or representative, resulting in a benefit to him / her or his / her relative.
- f) Award of benefits such as increase in salary or other remuneration, posting, promotion or recruitment of a relative of an employee of a Tata company, where such an individual is in a position to influence decisions with regard to such benefits.
- g) The interest of the company or the group can be compromised or defeated.

Notwithstanding such or any other instance of conflict of interest that exist due to historical reasons, adequate and full disclosure by interested employees shall be made to the company's management. It is also incumbent upon every employee to make a full disclosure of any interest which the employee or the employee's immediate family, including parents, spouse and children, may have in a family business or a company or firm that is a competitor, supplier, customer or distributor of or has other business dealings with his / her company. Upon a decision being taken in the matter, the employee concerned shall be required to take necessary action, as advised, to resolve / avoid the conflict.

If an employee fails to make the required disclosure and the management of its own accord becomes aware of an instance of conflict of interest that ought to have been disclosed by the employee, the management shall take a serious view of the matter and consider suitable disciplinary action against the employee.

Infosys Technologies Ltd.

(Excerpts from the Annual Report 2009-10)

“Corporate governance is about commitment to values and ethical business conduct. It is a set of laws, regulations, processes and customs affecting the way a company is directed, administered, controlled or managed. This includes its corporate and other structures, culture, policies and the manner in which it deals with various stakeholders. Some of the important best practices of corporate governance framework are timely and accurate disclosure of information regarding the financial situation, performance, ownership and governance of the Company....

Our corporate governance philosophy is based on the following principles :

- Satisfy the spirit of the law and not just the letter of the law. Corporate governance standards should go beyond the law
- Be transparent and maintain a high degree of disclosure levels. When in doubt, disclose
- Make a clear distinction between personal conveniences and corporate resources
- Communicate externally, in a truthful manner, about how the Company is run internally
- Comply with the laws in all the countries in which we operate
- Have a simple and transparent corporate structure driven solely by business needs
- Management is the trustee of the shareholders' capital and not the owner.

The Board of Directors is at the core of our corporate governance practice and oversees how the Management serves and protects the long-term interests of all our stakeholders. We believe that an active, well-informed and independent Board is necessary to ensure highest standards of corporate governance.

The majority of our Board, 8 out of 15, are independent members. Further, we have audit, compensation, investor grievance, nominations, and risk management committees, which comprise only independent directors.

The information regularly supplied to the Board includes:

- Annual operating plans and budgets, capital budgets and updates
- Quarterly results of our operating divisions or business segments
- Minutes of meetings of audit, compensation, nominations, risk management, and investor grievance committees as well as abstracts of circular resolutions passed. Also, the Board minutes of the subsidiary companies
- General notices of interest
- Dividend data
- Information on recruitment and remuneration of senior officers just below the Board level, including appointment or removal of the CFO and Company Secretary
- Materially important litigations, show cause, demand, prosecution and penalty notices
- Fatal or serious accidents, dangerous occurrences, and material effluent or pollution problems
- Any materially relevant default in financial obligations to and by us or substantial non-payment for goods sold by us
- Any issue that involves possible public or product liability claims of a substantial nature
- Details of joint ventures, acquisitions of companies or collaboration agreements

- Transactions that involve substantial payment toward goodwill, brand equity, or intellectual property
- Any significant development on the human resources aspect
- Sale of material nature, of investments, subsidiaries and assets, which are not in the normal course of business
- Details of foreign exchange exposure and the steps taken by the Management to limit risks of adverse exchange rate movement
- Non-compliance of any regulatory, statutory or listing requirements, as well as shareholder services such as non-payment of dividend and delays in share transfer.

Materially significant related party transactions

There have been no materially significant related party transactions, monetary transactions or relationships between the Company and directors, Management, subsidiary or relatives, except for those disclosed in the financial statements for the year ended March 31, 2010.

Audit committee charter

1. Primary objective:

The primary objective of the audit committee (the committee) of Infosys Technologies Limited (the Company) is to monitor and provide effective supervision of the Management's financial reporting process with a view to ensure accurate, timely and proper disclosures, and transparency, integrity and quality of financial reporting.

The committee oversees the work carried out in the financial reporting process by the Management, the internal auditors and the independent auditor, and notes the processes and safeguards employed by each..

Responsibilities:

The responsibilities include :

Review and pre-approve all related party transactions in the Company. For this purpose, the committee may designate a member who shall be responsible for pre-approving related party transactions.

Corporate Governance at Infosys – Related party transactions

- Corporate governance at Infosys stresses commitment to values and ethical business conduct.
- It includes compliance with laws, regulations, and there are systems and processes within the company which help direct, administer and manage the governance.
- Infosys has a well-informed and independent Board which is central to the corporate governance practice in the company and oversees how the Management serves and protects the long-term interests of all our stakeholders.
- There is an audit committee charter which requires monitoring and supervising the Management's financial reporting process and integrity quality of financial reporting.
- The audit committee reviews and pre-approves all related party transactions in the Company. There is also a disclosure on if there are such transactions between the Company and directors, Management, subsidiary or relatives.
