

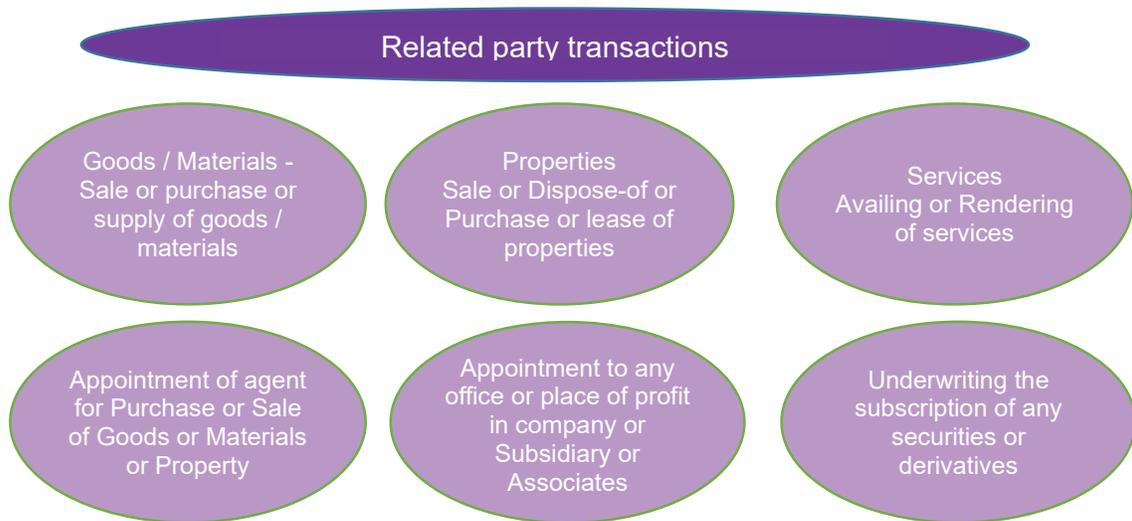
# Related Party Transaction in the new era of Corporate Governance

Nandakumar Raman

## i. Background:

Corporate Governance warrants an entity to comply with the applicable statutory regulations and to ensure that the transactions entered in to / proposed to be entered into is in the best interest of the entity, employees, investors and all other stakeholders. Corporate governance would have a direct impact on the profits and reputation of the entity concerned and having poor policies can expose the entity to law-suits, fines, reputational damage and loss of capital investment.

With corporate failures looming large, stakeholders are scrutinizing the decisions taken by the management (including the RPT), to ensure that their interests are not jeopardized. Hence, in addition to other evaluation processes, stakeholders carry out a detailed evaluation of the terms and conditions governing the RPT before approving it from a corporate governance perspective.



One of the critical component of Corporate Governance Regulations ("The Regulations") is to ensure that the Related Party Transactions ("RPT") are entered into in the best interests of the entity and all its stakeholders.

In the present environment, it is the responsibility of executive management to ensure that the terms and conditions governing the RPT comply with the arm's length requirement not only in **letter** but also in the **spirit** in which the Regulations have been laid down.

**ii. Related Party Transactions:**

Related Party Transactions has been defined to include:

**iii. Regulatory Requirements:**

The Regulations warrants that the RPT should comply with the arm's length standard and had

**iv. RPT - Term Sheet for approval:**

The Regulations warrant that the RPT be demonstrated to be in compliance with the arm's length requirement, while seeking prior approval of the AC / BoD. In this connection, following information may be compiled for the purpose of this analysis:

Related Party	<ul style="list-style-type: none"> <li>• Name, nature and particulars of relationship</li> </ul>
Contract / arrangement	<ul style="list-style-type: none"> <li>• Nature, duration, material terms, value of the contract and particulars of the contract or arrangement</li> <li>• Advance paid or received, towards the contract arrangement, if any</li> </ul>
Commercial Terms	<ul style="list-style-type: none"> <li>• Manner of determining the pricing and other commercial terms, both included as part of contract and not considered as part of the contract</li> </ul>
Other factors	<ul style="list-style-type: none"> <li>• Whether all factors of the contract has been considered, if not, the factors not considered and the rationale</li> <li>• Any other information, that is relevant or important for approval</li> </ul>

recommended to draw reference from the Indian Transfer Pricing Regulations ("TPR").

The Regulations warrants a prior from the Audit Committee (AC) / Board of Directors (BoD) for entering into a RPT. Hence, the terms and conditions and the value of the RPT has to be determined upfront and placed for prior approval of the AC / BoD. This poses a challenge in certain instances as the document to be placed for approval would be based on the proposed terms & conditions that would govern the transactions to be entered in the future. Hence adequate care has to be taken to ensure that the actual terms and conditions governing the transactions are in accordance with the proposed terms & conditions placed before the AC / BoD for approval.

**v. Benchmarking of RPT:**

The information compiled above may be benchmarked with the terms & conditions governing the transactions that would have been entered into between unrelated entities. The entity could consider the below methodology for the purpose of benchmarking the RPT.

**1. Sale of Goods / Rendering of Services:**

Sale of Goods / Rendering of Services could be split into two, (a) Generic Products / Services; and (b) Unique Transactions for the purpose of benchmarking:

**Generic Goods / Services:** Generic goods / services refers to transactions involving Off-the-shelf products or rendering standard set of services. For example, sale of a Motor Car or electric motor or rendering of BPO services involving similar skill sets

The transaction value and the terms & conditions governing the transactions with unrelated entities

involving same or similar goods / services in the current year or in the immediate past could be considered for the purpose of benchmarking the transactions proposed to be entered into with the related party.

It is recommended to prepare a term sheet comparing the terms & conditions of the transaction with unrelated entities vis-à-vis related party be prepared for the purpose demonstrating the compliance of the Regulations.

**(b) Unique Transactions:** Unique Transactions refers to Goods / services are tailor made to the requirement of the related party and the entity does not render same / similar services to unrelated entities.

Sale of Goods / Rendering of Services:

Goods: -

Entity transacting with related parties as well as unrelated entities:

Expected % of operating results (or) PLI (i.e., operating profit / operating cost %) from sale to related party / services to related party be benchmarked against the PLI from sale to unrelated entities involving same or similar products / services to unrelated entities.

Entity transacting only with related parties:

The PLI of independent entities engaged in same or similar transactions be identified from the publicly available information and benchmarked against the expected PLI from the proposed RPT.

AC / BoD as a policy may lay down an acceptable range (say @ 3%) and conclude that the proposed RPT satisfies the arm's length requirement, in case the RPT value is within the prescribed range from the arm's length value.

## 2. Purchase of Goods / Availing of Services:

Purchase of Goods / Availing of Services could be split into two, (a) Generic Products / Services; and (b) Unique Transactions for the purpose of benchmarking:

### (a) Generic Goods / Services

Goods: - Comparable quotes may be obtained from the open market and compared with the value of RPT to evaluate the arm's length compliance

Services: - Comparable quotes / hourly charge out rate for availing similar services from unrelated entities be obtained and compared with the value of RPT to evaluate the arm's length compliance.

### (b) Unique Transactions

- Purchase of goods:
  - Based on the activity and requisite efforts the value of the transactions be re-computed and benchmarked (or)
  - The operating profit / operating revenue % of the RPT be benchmarked with operating profit / operating revenue % of unrelated party transactions.
- Services:
  - The estimated rate per hour for the nature of service availed from related party be computed and benchmarked against the rate per hour of a similarly qualified and experienced unrelated resource.

AC / BoD may lay down an acceptable range and on the basis evaluate and conclude on the arm's length compliance of the proposed RPT.

**3. Buying / Selling / Disposing of a Property:**

**(a) Moveable property:**

- Comparable quotes for the same moveable property (or)
- Value determined on the basis of an open bidding process (or)
- Valuation report from an independent external valuer, with appropriate expertise

**(b) Immovable property:**

- Guideline value of the property could be a good indicator for the price of the property (or)
- Comparable quote from an unrelated entity, if available (or)
- Rate per square feet for same or similar property in a similar location be obtained and benchmarked (or)
- Valuation report from an independent external valuer, with appropriate expertise, could be obtained for benchmarking.

Obtaining a comparable quote or a report from an independent external valuer, would be the most recommended approach.

**4. Leasing of Property:**

(a) Rent paid / charged be compared to the rent paid / charged in case of properties leased from / to unrelated entities in similar geographical locations.

(b) In the case of leasing of facilities,

- The facilities and utilities provided / availed and the terms and conditions governing the same could be measured and compared to those offered by unrelated entities (or)
- The utilities provided by / to the lease / lessor can be measured against the benefits derived from it (or)
- Comparable quotes obtained from the open market (or)

- Market estimate from well-known property portals (or)
- Report from an independent valuer with appropriate expertise could be considered for benchmarking.

Lease rental agreement be reviewed on a periodic basis to ensure that the terms and conditions are in accordance with the prevailing market conditions.

**5. Agent's appointment for Purchase or Sale of Goods or property or services:**

- Terms of appointment of unrelated entities after making suitable adjustments for variation, if any (like volume off-take, commitment, credit period, promotion support, product warranty support, product return entitlement, discount and incentive structure, etc.) (or)
- The terms prevailing in the open market for similar products could be obtained and considered for benchmarking after carrying out adjustments for variations in the terms of the agreement, if any.

**6. Appointment of Related party to place of profit in the company or its subsidiary or its associates:**

- The qualification, past experience and expertise in the relevant field and the expected benefit for the company (or)
- Views and expectations of the management (or)
- Appointments considered and approved by the remuneration committee of the BoDs could be a guidance factor.

**7. Underwriting of Securities or derivatives:**

- Price charged by independent service providers for similar services could be considered, after carrying out adjustment for significant variation, if any,

- Reasons for selecting the identified service provider and the expected benefits be documented.

The AC / BoD may take into consideration the nature of transaction, basis of determination of the transaction value and the relevant terms & conditions and benchmark the same against comparable information involving transactions between unrelated entities and conclude on its compliance from an arm's length requirement.

laid down in The Regulations and that adequate processes have been established to ensure that the RPT entered by the entity does not jeopardize the interests of any of the stakeholders.

**vi. Annual Exercise:**

In addition to the above, it is recommended to carry out an exercise at the end of the financial year to evaluate as to whether the RPT entered into during the year are in compliance with the arm's length standard as prescribed in The Regulations.

**vii. Conclusion:**

The prevailing business scenario warrants every entity to ensure that the RPT entered into during the year complies with the arm's length standard as