

## ***Keeping it in the Family – Related Party Transactions and Safeguards for Investors***

Many corporations in India are largely promoter-driven family run businesses and typically, have controlling rights in the company. Financial investors, on the other hand, are looking to invest to make a good return on their initial investments and avoid holding substantial stakes in such companies due to reasons of lack of transparency, compliance issues, and concentrated ownerships in family-run businesses. As such, while evaluating companies, understanding the shareholding structure is critical from both a control and growth perspective.

A scattered shareholding structure with a multitude of owners owning a sliver of shareholding in the company can be painful to deal with but the contrary is where companies have concentrated shareholdings, where such few key shareholders would determine the way-forward for the business. More often than not, such concentrated shareholdings in large corporations are family-owned businesses, with preferences to implement the business through known / related parties.

### **What is a related party transaction?**

A related party transaction (RPT) under the Companies Act, 2013 (“**Act**”) broadly means a transaction with a company and its director / relative / key managerial personnel / or any firm, entity with these individuals as partners, directors or any person on whose advice, directions or instructions a director or manager is accustomed to act.

It is also defined under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“**LODR Regulations**”) for listed entities, as a transaction involving a transfer of resources, services or obligations between, (i) a listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or (ii) a listed entity or any of its subsidiaries on one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries. For the purposes of the LODR Regulations, related parties include those covered under the Act (*as mentioned above*), as well as members of the promoter group and any person or entity holding 10% or more of the listed entity’s equity shares, either directly or beneficially, at any time during the preceding financial year.

Under Indian Accounting Standards (“**Ind AS**”), an RPT is broadly set out as a transaction between an entity preparing its financial statements (“**Reporting Entity**”) and a person related to the Reporting Entity. As per Ind AS, a person or a member of that person’s family is related to the Reporting Entity if that person, *inter alia*, (i) has control of or significant influence over the Reporting Entity; or (ii) is key managerial personnel of the Reporting Entity or a parent of the Reporting Entity. Further, an entity is a related to the Reporting Entity if, *inter alia*, (x) the entity and the Reporting Entity are members of the same group of companies or under common control; (y) one entity is an associate or joint venture of the other entity; (z) both entities are joint ventures of the same third party.

As evidenced by recent reports, related party transactions can be concerning for companies, with allegations ranging from embezzlement to fraud in various well-known companies. Fiascos involving related party transactions are not new: from Enron to IL&FS, fraudulent related party dealings are an endemic issue plaguing corporations across the world, often leaving investors holding the bag. In this piece, we explore what financial investors and shareholders can do to safeguard themselves from ending up in that position.

### **Spotting a suspicious related party transaction**

By the time the mess from related party transactions comes to light, the cat's already out of the bag, and there's little that the shareholders can do to soften the blow. The following are certain safeguards that a company can implement in order to spot suspicious related party transactions:

- (i) **Implement whistleblower policies:** Whistleblower policies can help uncover undisclosed related party transactions that are not on arm's length basis, as whistleblowers would have access to information that is not provided to the management. Conflicts of interest and insider information on unethical transactions can be detected if management supports best practices to encourage whistleblowers, including on an anonymous basis to report suspicious transactions.
- (ii) **Reporting of RPTs by auditors:** Auditors must report details of RPTs, including the type of transaction, parties and price involved so it helps determine the non-compliances and monitor transactions undertaken. However, the management must co-operate in such situations and provide information to facilitate fact finding for auditors.
- (iii) **Review of audited financial statements:** A review of audited financial statements and notes to accounts can give shareholders a clear picture of the related party transactions undertaken by the company. If the transactions are significant in quantum, it is advisable for shareholders to delve into the details and discuss them with the management of the company. If needed, independent review of underlying receipts and documents by the shareholder's or investor's financial advisors can provide additional comfort.
- (iv) **Minutes of the meetings:** Investors should pay close attention to the minutes of board and shareholder meetings, disclosures, as they often reveal significant transactions undertaken during the financial year. If it appears that the company has engaged with an unfamiliar entity or on terms that are not on an arm's length basis, it's worth investigating further.
- (v) **Loans to related parties:** Frequent loans provided to related parties that are not accounted for or approved at the board or shareholder level are red flags and should be investigated to determine legitimacy and purpose of such loans.
- (vi) **Lift the corporate veil:** Businesses often involve a small group of vendors or customers. Investors should investigate these entities and check for links to promoters, CxOs, or directors and frequency of transactions undertaken with these entities, if maintained at arm's length basis.
- (vii) **Timing of transactions:** The promoters of a company may scamper before the end of the financial year or quarters to boost its earnings and other financial metrics, as well as to display inflated valuations. Unusual transactions scattered through important points in time such as end of a financial year or quarter may be a potential red flag to look out for.

Rigorously analysing financial statements, scrutinizing board minutes, probing related entities, and tracking the timing of transactions would help investors uncover red flags before it's too late. For financial investors, and retail investors, early detection of questionable related party transactions can help prevent nightmares in the future. Time and again, we are reminded of the importance of approaching RPTs with caution. No investor wants to explain to their stakeholders or limited partners that they failed to check for or missed the signs of fraudulent related party dealings leading to unprecedented consequences for all parties involved.