

RELATED PARTY TRANSACTIONS FROM AUDITOR'S LENS



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Virtually every business has transactions with related parties. They are a business necessity. Businesses have related entities and they transact in a regular and routine manner. These could be genuine transactions executed in the same manner as any other transaction with a non-related party. However, of late Related Party Transactions (RPTs) has taken negative connotation. The transactions among related parties have assumed greater importance in all the fields of businesses viz., fiscal, accounting and also as a matter of corporate governance. Perhaps, corporate governance significance is more in forte considering the fairness, transparency and accountability while conducting business.

In India, RPTs assume more significance due to the nature of Indian business houses, which are primarily promoter-led and consist of family business structures. It is perceived by the investor community that higher related party transactions means lack of governance and it may not be in the best interest of the organization.

Current debacles in the corporate governance relating to RPTs of many listed and reputed companies are raising questions and clicking alarm for the regulators to relook at the duties and responsibilities of all those charged with governance. Failure of conflict of interest in most of these cases generally takes the minority shareholders for a ride, but these issues need more deliberations and are not specifically covered in this article. Regulatory aspects of RPTs with respect to Companies Act, SEBI (LODR), Income Tax Act, GST Act, Transfer Pricing are dealt with by other articles in this special series on 'Related Party Transactions'. This article attempts to analyse related party transactions from auditor's point of view.

Definition of a Related Party and Related Party Transactions under GAAPs:

Definition of related party as per both GAAP's are as follows:

	AS-18	Ind AS-24
Relative	in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.	A person or a close member of that person's family are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including: <ul style="list-style-type: none"> i. that person's children, spouse or domestic partner, brother, sister, father and mother; ii. children of that person's spouse or domestic partner; and iii. dependents of that person or that person's spouse or domestic partner.
Related Party	parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions	An entity is related to a reporting entity if any of the following conditions applies: <ul style="list-style-type: none"> i. The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). ii. One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member). iii. Both entities are joint ventures of the same third party. iv. One entity is a joint venture of a third entity and the other entity is an associate of the third entity. v. The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. vi. The entity is controlled or jointly controlled by a person. vii. A person identified has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). viii. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.
Related Party Transactions	a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.	a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

As can be seen from the above definitions, definition as per Ind AS 24 is much wider than AS 18 for relative and related party. Also, definitions of Control, Significant Influence and Joint Control are much wider in respective Ind AS as compared to AS 18. Ind AS 24 also covers certain relationships not covered under AS 18 such as joint ventures of the same venturer, joint venture and associate of the same party, certain post-employment benefit plans, parties providing KMP services, etc.

One thing to note is that accounting standard framework defines related party relationships and prescribes disclosures to be made in the financial statements for such transactions with certain exemptions. Accounting standards framework does not establish any recognition or measurement requirements for related party transactions. Such transactions are recognized and measured based on the requirements of the respective accounting standards. For eg: if the parent company gives collateral security for borrowings taken in subsidiary for acquisition of asset, then such transactions have to be recognised as per accounting standard on borrowing costs.

Identification of related parties under the Companies Act is not based on the principle of reciprocity. That means, it is possible that one company identifies other company as its related party. However, it does not necessarily mean that the second company will also identify the first one as its related party. Sec 188 of the Act specifies various contracts or arrangements with a related party which constitute a related party transaction. Hence, there is no express definition of the term RPT but only a list of contracts or arrangements which constitute one. It may be noted that the scope of RPTs under section 188 is restricted only to the types of contracts or arrangements specified under the section. Further, Rule 15 of the Companies (Meeting of Board and its Powers) Rules treat certain RPTs as prescribed RPTs where the transaction value is above respective threshold limit, for which a special resolution of the shareholders is required.

Issues and clarifications in Related Party Transactions:

Since the transactions with related parties are molded sometimes in different forms and structures, it is imperative for the regulator to include all such related parties and RPTs under the purview of these provisions. There are still some issues and clarifications relating to related party and RPTs, which are as follows:

- **Accustomed to act:** Whenever any director, of the company, on whose directions or instructions the BoD, managing director or manager of the body corporate is accustomed to act is called a “Deemed Director”. The influence of such deemed director must be real but need not extend over the whole of the company's activities. In case of sec 188, the Act expressly provides that it does not include a person who gives advice to the board in a professional capacity. Same exception is provided in the definition of officer u/s 2(59) and promoter u/s 2(69). Thus, it can be inferred that except where the Act provides this exception (for eg. Sec 185 Loans to Directors) even the directions or instructions of a person, including in the professional capacity, will be deemed as related party.
- The phrase “ordinary course of business” is not specifically defined under the Act. The Allahabad High Court has observed that for a transaction to be construed to have occurred in the regular course/ usual course of business, there must be “an element of continuity and habit for it to constitute the exercise of a profession and business.” The frequency of transactions over a period of time should not be the only criterion and it cannot be restricted to the core business activities of a company alone. Support services that do not form part of the main core activity of a business, but are nevertheless necessary and ancillary for running the core business, can also be considered as transactions that happen during the ordinary course of business

- **Key Managerial Personnel:** Ind AS 24 defines KMP as persons having authority and responsibility for planning directing and controlling the activities of the entity. With this definition, executive directors of the company will usually be covered since they carry such authority and responsibility. The definition also includes any director, whether executive or otherwise. Therefore, even non-executive directors who have such authority and responsibility are KMPs of the company. KMPs are not restricted to directors. Other senior management members may also be KMPs for eg: CFO, Chief Legal Officer, Chief Marketing Officer, Chief Executive Officer, etc. The company needs to evaluate their roles and determine whether they have the above mentioned authority and responsibility or not. It is not the designation but the role that the individual plays that determines whether he/she is a KMP or not. Therefore, all directors may not be KMPs and KMPs need not only be directors.
- **Body Corporate:** Definition of related party used the word 'company' under clause (viii) of section 2(76). There was an anomaly with regard to foreign companies because a foreign company is not a company as per the Act, it is a body corporate. Thus, the consequence of this would interpret those companies/ entities incorporated outside India, such as foreign holding/subsidiary/associate/ fellow subsidiary of an Indian company are excluded from related party requirements. To address this issue, Companies Amendment Act 2017 has substituted the word 'company' with the word 'body corporate'.
- **Relationship period:** Another interesting issue is what is the scope of requirement if the relationship ceases or new relationship gets established during the reporting period. Whether related parties should be considered as at the year end? Though accounting standards do not explicitly cover this matter, relationships should be covered during the period, and not only at the year end. Transactions taking place after cessation of relationships are not considered as related party transactions.

Auditor's approach for the audit of Related Party Transactions: and issues faced during audit of RPT:

Audit of a related party transactions is always a challenge for the auditor. Skepticism for such transactions is set at higher limits for the auditor. Objective of Standards on Auditing (SA) 550 – Related Parties are to obtain an understanding of related party relationships and transactions sufficient to be able to recognise fraud risk factors arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud and whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework

1. Identification of Related Party and RPT is the primary step:

The source point of this would be the entity's mechanism of identifying the related parties. The way an organization deals with its related parties speaks volumes about the culture and integrity of the decision makers, i.e., the management. Have the directors given their self-declarations? Has the entity filed declarations with MCA or with tax authorities or custom authorities for cross border transactions? Has the entity given any declaration to its bankers or lenders with respect to related parties?

A major risk of audit is not identifying all the related parties and, on the basis of the above information, the auditor needs to determine whether reliance can be placed upon the information furnished. In case the auditor determines that complete reliance is not possible, he will need to scrutinize further. Some of the general scrutiny processes are entities with similar sounding names or pattern of names, entities structured as trusts, entities where one of the director is director/ shareholder and so on.

2. Rationale of RPT is the next step:

The auditor needs to understand business rationale for such transactions. When such rationale is lacking, it may not meet the small test and would require additional audit procedures to be carried out to fulfill auditor's responsibility and understand impact of such transactions on the financial statements. There is also a possibility of non-genuine transactions being recorded when the counterparty is a related party.

3. Analysing pricing of RPT is the last step:

As part of the audit process, apart from the business rationale as mentioned above, the auditor should also evaluate the consideration received or paid for such transactions to assess whether those transactions were carried out at arm's length or not. Pricing is the culmination of a business process that involves recommendation and approval by the persons who have the authority to do so. If the transactions are not at arm's length, then the reasons for determining such pricing, its impact on accounting of such transactions, etc. are additional factors that the auditor should consider. As an auditor the focus will be on the mechanism of the company to ensure that the transaction is priced appropriately. Information and inquiry will help the audit process:

Does the entity have a pricing policy for RPT's?

Is it clear and unambiguous?

Is it applied uniformly and consistently?

Does the policy permit deviations? If so, how are the deviations authorized?

4. Approval of RPT by the authority is the next step:

Approval process of RPT has become little complex and should be examined whether transactions are approved as per the regulatory provisions. Depending upon whether the RPT is in the ordinary course of business and on an arm's length pricing, the compliances required by a private/ public company under the Act are as follows:

Compliances	If RPT in Ordinary Course of business and on ALP basis	If RPT not in Ordinary course of business or not on ALP basis
Whether Audit Committee's approval required for all RPTs, whether prescribed or not?	Yes as per sec.177	Yes as per sec.177
Whether consent of the Board of Directors required for all non-prescribed RPTs?	No	Yes
Whether ordinary resolution by members required for all non-prescribed RPTs?	No	No
Whether consent of Board of Directors and ordinary resolution by members required for prescribed RPTs	Not required. May be placed to Board for information only.	Yes
Whether RPT to be referred in Directors' Report along with justification for the same?	No	Yes

From the above table, it is clear that transactions in ordinary course of business and on arm's length basis would not require approval of the shareholders. Also, transactions between holding company and wholly owned subsidiary (WOS) company whose accounts are consolidated and laid before shareholders at AGM would not require approval of the shareholders. The Audit Committee is also empowered to give an 'omnibus' approval for transactions up to Rs.1 crore i.e. a pre-approval for all RPTs proposed to be entered into by the company during a financial year subject to certain criteria to be defined by the Audit Committee. It should be noted that the Act does not clarify whether related party transactions must be first approved by the Board or the Audit Committee. If the Board approves a transaction, but the Audit Committee withholds consent it would pose challenges to the company.

1. Communicating to Those Charged with Governance is the last step:

Communicating significant matters arising during the audit in connection with the entity's related party's transaction helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Generally, Audit Committee must create opportunities for direct, periodic interactions between the auditors and the Audit Committee members in the normal course of business. It sometimes enables auditors to escalate the issues directly relating to governance matters. Reporting on issues related to RP and RPT is sensitive and requires tactful communication.

Conclusion:

In the past, large frauds have been detected in which Related Parties were involved. In many instances, special purpose entities were formed without substantial ownership in its equity to circumvent the law. Generally, in private or closely held public companies, domination of management by single or small group of persons may increase the risk of fraud. People at large outside any business group, view RPTs with an inherent negative sense of conjecture and assumption. On the other hand employees of many business organizations consider all regulatory provisions and mandates from internal governance framework as hurdles. Thus, there has been a constant yo-yo between promoters and minority share holders with each crying foul and each claiming victory.

Companies often seek business deals with entities to which they are familiar with or have been connected with their directors or KMPs. RPTs must have to be there as they form the very rational and basis of many Mergers & Acquisitions deals. While these types of transactions are legal, the special relationship inherent between the involved parties creates potential conflicts of interest.

In the present environment where laws are evolving to insert greater transparency in the dealings of business, RPT will only be further scrutinized. Therefore, greater responsibility on directors and liability on auditors have always been on regulator's mind.

