A STUDY ON RELATED PARTIES TRANSACTIONS IN INDIA

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Introduction to Related Party Transactions

- Companies are primarily engaged in exchange of assets, goods, resources, services or obligations with each another. **Related party transaction occurs when these exchanges/transaction or deals are carried on between the parties who have a pre-existing relationship , where one of it may have control over the other , or may have interest in the company or both fall under same control.**

- Companies often try to operate with such entities that are in control under it or whom they are familiar with so a to generate synergies in terms of Cost-efficiency; Quality & standards ; Ease of doing business – in terms of turnaround time ; Customization and Trust.

- However, this creates major concern around ;
  - Pricing- The deal /transaction which may or may not taken place on Arm's Length Transaction which can be possible be case of conflicts of interest thereby impacting the minority shareholders wealth;
  - Transparency - Failing of Material Disclosures to be made in terms of pre-exiting relationship or interest in companies,
  - Wrong Doing - Practices that are/can potentially pose undue favor to shareholder's interest.

- There are well defined laws, rules, regulations or norms which are widespread and are getting rationalized regularly especially on reporting or disclosures to be made to protect the minority shareholders.

- Regulators , Acts and Standards have explicit and detail of Related Parties which includes - Definitions , relationships , interests , locations , threshold limits , special approvals needed in some cases ; disclosures requirements, approvals needed and many more.

- Companies still have entered into significant Related Party Transactions which creates issues of Principal – Agency Conflict

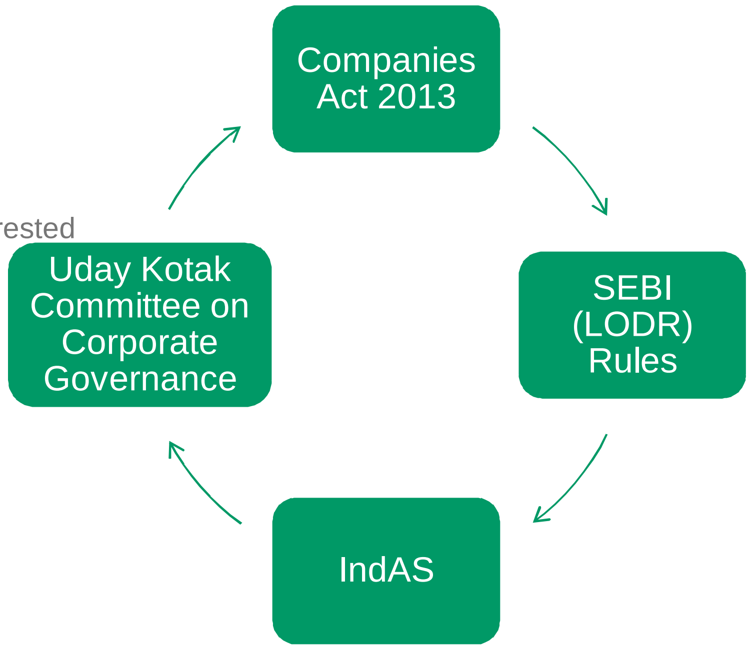
Existing Rules/Regulations – Companies Act, SEBI(LODR), Accounting Standards

- **Companies Act, 2013 :**
  - Sec 2(76) and 2(77) of the Companies Act, 2013
  - Rule 4 of Companies (Specifications of definitions details) Rules , 2014
  - Section 177, 188, 189 of the Companies Act, 2013
  - Rule 6(A), Rule 15 and Rule 16 of Companies (Meetings) of Boards and its Powers) Rules , 2014
  - Companies (Amendment) Bill, 2016
  - Form MBP- 4
  - Disclosure in Board Report
  - Other Sections :
    - Section 177 – Audit Committee
    - Section 184 – Disclosure of Interest by Director
    - Section 185 – Loans to Directors
    - Section 186 – Loan & Investment (including Guarantees) by Company
    - Section 189 – Register of contracts or arrangements in which directors are interested
    - Section 193 – Contract by One person Company

- **SEBI Listing Obligations and Disclosures Requirements Regulations 2015**
  - Regulation 2(1)(zb) and 2(1)(zc)
  - Regulation 23
  - Schedule II
  - Policy of Related Party Transactions
  - Corporate Governance Report Provisions
  - Omnibus Approval under LODR

- **Indian Accounting Standard – 24 (Ind AS -24)**

- **Uday Kotak Committee Report (Recommendations) on Corporate Governance**



Methodology

- ***Nifty Companies are often a representative of what is happening in other Listed companies. Related Party Transactions which have started happening in Nifty Companies are expected to be more prevalent in other listed companies, since they are exposed to lesser scrutiny.***
- *Analysis is based on the Consolidated reporting reported by companies in their respective annual reports.*
- *Analysis includes Nifty companies , however, it excludes the Non-Bank Financing Institutions , Public Sector companies and Banks.*

  List of companies analyzed is mentioned separately.
- *All numbers are converted to crores and total may not match due to rounding off.*
- Dividend Paid is not considered for reporting, because dividend by nature is given to all shareholders in proportion to their interest in the firm and is technically not a related party transaction that merits attention.
- Related party transactions were broadly classified into following types:

Transactions during the year

Nature of Transaction	Computed as a % of
• Sales	Total Revenue
• Purchases	EBITDA
• Interest Income	EBITDA
• Interest Expense	EBITDA
• Others(including Royalty)	EBITDA

Balances at end of the year

Nature of Transaction	Computed as a % of
• Funds Deployed (New + Outstanding)	Networth
• Funds Received (New + Outstanding)	Networth
• Guarantees Given	Networth
• Guarantees Taken	Networth

List of Companies Covered

- Adani Ports & Special Economic Zone
- Asian Paints Ltd.
- Bajaj Auto Ltd.
- Bharti Airtel Ltd.
- Bharti Infratel Ltd.
- Britannia Industries Ltd.
- Cipla Ltd.
- Dr. Reddy's Laboratories Ltd.
- Eicher Motors Ltd.
- Grasim Industries Ltd.
- HCL Technologies Ltd.
- Hero MotoCorp Ltd.
- Hindalco Industries Ltd.
- Hindustan Unilever Ltd.
- ITC Ltd.
- Infosys Ltd.
- JSW Steel Ltd.
- Larsen & Toubro Ltd.
- Mahindra & Mahindra Ltd.
- Maruti Suzuki India Ltd.
- Reliance Industries Ltd.
- Sun Pharmaceutical Industries Ltd.
- Tata Consultancy Services Ltd.
- Tata Motors Ltd.
- Tata Steel Ltd.
- Tech Mahindra Ltd.
- Titan Company Ltd.
- UPL Ltd.
- UltraTech Cement Ltd.
- Vedanta Ltd.
- Wipro Ltd.
- Zee Entertainment Enterprises Ltd.

Key Findings

Main Issues observed

- Increasing Trend in Related Party Transactions from FY14 to FY18
- Newer Areas of RPT Transactions have developed
- Family Controlled Entities have Higher Related Party Transaction
- Spirit of Law not being followed

- Use of Shareholders funds to lend support to new ventures of Promoter Group
- Identity of parties is often skipped
- No Explanation/Fairness Opinion
- Risks not Highlighted
- No Fixed Format for Reporting

Increasing trend in Related Party Transactions

- The average value of RPTs per year has shown an increasing trend most cases that were studied.
- Related Party Sales has increased at a CAGR of almost 16.5% from ~20,800 Crores (1.1% of total revenue) in FY 14, to ~44,700 Crores (2% of total revenue) by FY18
- Related Party Purchases have increased at a CAGR of almost 14% from ~41,400 Crores (12.6%) in FY14, to 79,700 Crores (17.6%) by FY18
- Net outstanding investments in Related Party Companies have increased at a CAGR of 8.6 % from ~8700 Crores in FY14 to 13,200 Crores in FY18

Family Controlled Entities have Higher Related Party Transaction

- The average value of RPTs per year, for each of the different transactions impacting the Balance Sheet, P&L, and Guarantees, is higher for companies which belong to a Family Group.
- MNC/Professionally controlled entities have lower value of Related Party Transactions

No Fixed Format for Reporting

- Companies do not follow fixed format for reporting Related Party Transactions.
- They chose a format as per their convenience and often choose to fragment data in different parts of annual report making it hard for user of financial statement to get a complete view in one place.
- A Infrastructure Major Does not disclose names of Related Parties with which 10% of the transaction has been done, whereas all other companies report it.
- A FMCG Co has close to 350 Crore of Inter Corporate Deposits placed with related parties which have been clubbed under Outstanding Receivables/Payables, without specifically disclosing the nature of outstanding.

Newer Areas of RPT Transactions

- **There has been an increasing trend to pay Management Fees/Royalty to Holding or Promoter Entities.** Companies are not only increasing the existing Royalties/Brand Management Fees, but some companies have suddenly after years of existence decided to enter into such agreements with Promoter Group. Other expenses (including Royalty has increased at a CAGR of 14% of FY14 to FY18
- There have been cases where **Related Parties are used for mandatory CSR Expense**
- Guarantees and Investments in Related Party entities have emerged as new RPT Transactions.
- Company assets are also being provided as Guarantee for loans taken by Related Parties.

Spirit of Law not being followed

- Companies take use of technicality of law to evade spirit of the reporting,
- In a Pharma Major a related entity to which 30% of sales were done in 2017-18, was not disclosed as a related party in earlier years, merely because promoter did not hold substantial shares, ignoring the fact that entity was still virtually controlled by Key Management. It is only when Cos Act rules became stricter that this co was disclosed as Related Party.
- Cos might be using technicality of law (minimum shareholding threshold etc) to avoid reporting entities as Related Party
- There appears to be little consistency regarding how companies interpret what relationships and what transactions need to be disclosed, and in what level of detail. Only bare minimum information is provided

Use of Shareholders funds to lend support to new ventures of Promoter Group

- Shareholders Funds are being used to fund new ventures of Promoter Group. Companies are providing quasi debt to promoter Group Cos
- A Infra and a FMCG Co have given Intercompany Deposits to promoter group entities to pursue business opportunities, instead of company directly pursuing those opportunities or taking an equity stake in those entities
- In an Auto Co- Almost 10% of Net worth of FY2014 was used to give Inter Corporate Deposits to Hero Fincorp during the year, but repaid before end of year so that it doesn't remain outstanding at end of year.
- During the year 2017-18, related parties of a Infra co took loan of 6100 Crore which was repaid fully before end of year, thereby not getting shown in Closing Balance Sheet

Identity of parties is often skipped

- Companies often do not disclose the specific value and name of the entity with which they have entered into transactions. This is just clubbed under broad heads such as Associates, JV's , KMP Controlled Entities
- **There is a case of large conglomerate having many listed entities -** In all the entities the names of Related Party have not been disclosed in the Related Party Schedule, and instead a blanket statement has been mentioned that "The company's Related Parties principally consist of XYZ Ltd, Subsidiaries and Joint Arrangements of XYZ, the Company's associates and their subsidiaries, joint operations and joint ventures of the company'

No Explanation/Fairness Opinion

- The numbers are presented with virtually no context or explanation, leaving doubts hanging as to whether a conflict of interest is lurking behind them
- Shareholders do not receive enough information from Annual Report about related party transactions to make informed investment and voting decisions. There is no opinion on comparable options to make judgement on whether to approve the transaction or not.

Risks not highlighted – 'Framing'

- Framing a statement differently leads to different results
- As of now, all shareholder voting resolutions provide the details of related party and the transaction being entered into.
- However the Audit Committee/Board should provide reasons what are the risks in the related party transactions that are being proposed for voting
- This will not only ensure that Risks are highlighted upfront to the shareholder , which will result in better participation and different voting results

Detailed Analysis

Sales as a % of Total Revenue

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Why is it important

- Sales as a % of total revenue has been compared to judge how much of revenue has been generated by sale to outside parties.
- Unrealistic business commitments and high valuation expectations have often induced promoters to sell to related parties to meet targets.
- **A close watch on this is essential to know fundamental strength of company and ability of company to do competitive sales.**

Cos may form listed subsidiaries with Substantial Related Party Sales just to garner valuation

Trend

- Over a period of 5 years from FY14 to FY18, approx 1.4% of the revenue generated has been through sales done to related parties
- The value of such transactions have increased at a CAGR of almost 16.5% from ~20,800 Crores (1.1%) in FY 14, to ~44,700 Crores (2%) by 2017-18
- While during the same time the sale have grown by only 4% CAGR

Outliers and Observations

- **Infra Co** – Substantial revenues are derived from related party transactions with Joint Ventures
- **Telecom Co** – Almost 50% revenue is derived from transactions with Parent co and fellow subsidiaries.
- **Media Co**- Substantial revenue is derived from transaction with entities which are controlled by KMP .
- **Pharma Co** suddenly reported huge related party sales in 2017-18. What is interesting is that the company has been doing transactions with this co since 2006, but this was not disclosed as a Related Party in previous years and hence the quantum of transaction is unknown

Purchases as a % of Total EBITDA

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Why is it important

- Purchase as % of total EBITDA has been compared to judge how much of EBITDA attributable to ***stakeholders*** (profits, interest and taxes) may have been abstracted to related parties.
- The risk here is that stakeholders may be denied their rightful share if purchases are not done at arms length price.
- A high % of such transactions also raises questions of ***principal-agency conflict***, especially in today's world where organisations always have multiple options to purchase products/services from non related entities at equally competitive prices.

Trend

- Over a period of 5 years from FY14 to FY18 , the sample cos have done purchases from related parties of a value of approx 14.7% of the EBITDA
- The value of such transactions have increased at a CAGR of almost 14% from ~41,400 Crores (12.6%) in FY14, to 79,700 Crores (17.6%) by FY18
- While during the same time the EBITDA has grown by only 6.6% CAGR

Outliers and Observations

- **Auto Co 1** – Purchases from entities controlled by KMP are almost 50% of EBITDA
- **Commodity Co** - Purchases from related entities controlled are almost 120% of EBITDA
- **Auto Co 2**- Purchases from unconsolidated entities are almost 100% of EBITDA

Others (including Royalty) as a % of Total EBITDA

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Why is it important

- Other payments (including Royalty) as % of total EBITDA has been compared to judge how much of EBITDA attributable to ***stakeholders*** (profits, interest and taxes) may have been abstracted to related parties.
- The risk here is that stakeholders may be denied their rightful share if other payments are not done at arms length price.
- **A high % of such transactions also raises questions of principal-agency conflict.**

Trend

- **There has been an increasing trend to pay Management Fees/Royalty to Holding/Promoter Entities**
- Over a period of 5 years from FY14 to FY 18, the sample cos have done purchases from related parties of a value of approx 2.6% of the EBITDA.
- The value of such transactions have increased at a CAGR of almost 14% from ~6,500 Crores (2%) in FY14, to ~12,700 Crores (2.8%) by 2017-18
- While during the same time the EBITDA has grown by only 6.6% CAGR

Outliers and Observations

- **Commodity Co**– Unrecoverable balances of almost 1000 crores have been written off each year since 2016
- **Auto Co** – Royalty paid to Holding Co has been consistently above 30% of EBITDA. ***Co also is paying money for other expenses to subsidiary of parent (which is in the same line of business). This is a big conflict issue***
- **Conglomerate** - Almost 1% of EBITDA is appropriated towards Donation to Related Parties

Interest Income as a % of Total EBITDA

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Why is it important

- Interest Income as % of total EBITDA has been compared to judge how much of EBITDA may have arisen by generating interest income by giving loans to unconsolidated entities.
- Companies Act 2013 had mandated that no interest free loans can be given, but Risk here is of Capital Misallocation.
- **A high % of such transactions raises questions on Capital Allocation of the company, since shareholders wealth is being used for providing loans to related parties.**

Trend

- Over a period of 5 years from FY14 to FY18, the sample cos have done interest income from related parties of a value of approx 0.2% of the EBITDA
- The value of such transactions have marginally reduced at a CAGR of 2.3% from ~790 Crores (0.2%) in FY14 to ~700 Crores (0.2%) by 2017-18

Outliers and Observations

- **Infra Co** – interest income has been as high as 8% of EBITDA but it has gradually come down , though is still at 2.5%. Loans have been extended to JV's and entities controlled by KMP
- **FMCG Co** - where interest income has been as high as 2% of EBITDA due to loans given to non consolidated entities.

Interest Expenses as a % of Total EBITDA

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Why is it important

- Interest Expense as % of total EBITDA has been compared to judge how much of EBITDA may have may have diluted to unconsolidated entities by taking loans from them.
- **A high % of such transactions raises questions as to why organization cannot take loans from financial institutions and why would related parties have a debt exposure to the entity rather than an equity exposure.**

Trend

- Interest expense transactions have been limited in the companies covered under sample size, and have reduced over the years

Outliers and Observations

Funds Deployed (New + Outstanding) as a % of Net worth

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Why is it important

- To check ***how much of networth has been blocked*** in supporting finance needs of related parties ***instead of earning return for shareholder.***
- **In a some cases, the fund are being deployed during the year and taken before end of financial year so that the amount doesn't show up on Balance Sheet.**
- Here we have also included value of funds which are available to the company due to Debtors/Creditors arising out of P&L Transactions. This was to check if any non-normal trend is observed and indirect funding has happened. ***However this data point looked normal***

Trend

- Over a period of 5 years from FY14 to FY18, the sample companies have on an average deployed almost 4% of their net worth into related parties.
- In none of the year, the net funds deployed for related party investments have reduced
- In fact the net outstanding investments have increased at a CAGR of 8.6 % from ~8700 Crores in FY14 to 13,200 Crores in FY18
- During the same period Net Worth of sample set companies have also increased by 8.3%

Outliers and Observations

- **FMCG Co** – has not reported closing balances of Intercorporate deposits in the Related Party Schedule even though value of such deposits is almost 1000 Crores
- **Commodity Co** - Loans have been given entities controlled by Holding Co. **The loans are not given by the standalone entity but by subsidiaries. Further loans taken and fully repaid during the year are not disclosed.**
- **Auto Co** - Almost 14% of Networth of FY2014 was used to give Inter Corporate Deposits which were repaid within the year. Another 7% was deployed FY2015
- **Infra Co**– The company is taking funds from related parties and further redeploying them to other related entities. Over the last 5 years it has taken Rs. 8800 Crores from Related Entities and redeployed 10,000 Crores further

Funds Received (New + Outstanding) as a % of Net worth

Why is it important

- To check ***how much of networth has been blocked*** in supporting finance needs of related parties ***instead of earning return for shareholder.***
- **In a some cases, the fund are being deployed during the year and taken before end of financial year so that the amount doesn't show up on Balance Sheet.**
- Here we have also included value of funds which are available to the company due to Debtors/Creditors arising out of P&L Transactions. This was to check if any non-normal trend is observed and indirect funding has happened. ***However this data point looked normal***

Trend

- This route has not been used much except by few companies.
- This might be due to sampling, since most Nifty companies being bigger are more likely to give loans and deposits than take funds

Outliers and Observations

- **Infra Co** – The company is taking funds from related parties and further redeploying them to other related entities. Over the last 5 years it has taken Rs. 8800 Crores from Related Entities and redeployed 10,000 Crores further
- **Commodity Co 1**– On an average funds equal to 12% of net-worth is available in term of credit from related parties through which purchase of material/rental assets have been undertaken.
- **Commodity Co 2** – had taken loans from related parties which totaled almost 15% of networth as on FY16. This loan has been subsequently paid off.

Guarantees (Given + Taken) as a % of Net worth

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Why is it important

- These are Bank guarantees given/taken to/from related parties to support them/take support in business operations
- This route has been primarily used by companies which are part of a family group of companies.

Trend

- Guarantees given and taken are generally found in companies with high level of borrowing and where inter-cooperate loans and advances are high. This might have a correlation with the debt profile of the related parties and pose a huge risk.

Outliers and Observations

- **Infra Co** – The company has both taken and given guarantees for related party entities for values as high as 35% of networth. In FY18, the company has taken Corporate Guarantee from unconsolidated related entities and then further given similar amount of guarantees to other unconsolidated related entities
- **Commodity Co** – had taken huge corporate guarantees in earlier years from its Holding Cos which now has been relinquished. These Guarantees were almost equal to 30% of the Networth , raising questions on debt profile of the entity.

No of Related Parties

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Why is it important

- The Higher the number of Related Parties, more difficult is for the minority shareholder to analyse the data
- Companies too, end up not giving data on specific transactions with each related party due to volume of data and cost of providing the data vs the benefit

Trend

- Over a period of 5 years from FY14 to FY18, the number of Related Parties has increased from 1257 entities to 1730 entities (excluding Tata Group)

Outliers and Observations

- **Conglomerate -** In all the three entities the names of Related Party have not been disclosed in the Related Party Schedule, and instead a blanket statement has been mentioned that “The company’s Related Parties principally consist of XYZ Ltd, Subsidiaries and Joint Arrangements of XYZ Ltd, the Company’s associates and their subsidiaries, joint operations and joint ventures of the company’

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Specific Case Studies and instances of Transactions challenged by shareholders in non sample set companies

Infra Co

Key Observations:

- On an average, over the past 5 years, ***23% of Annual Revenues*** *have been generated by sales to related parties*
- On an average, over the past 5 years, **over 40% of Net Worth** has been used for Guarantees given to its related parties.
- Balances of Loans Given to related parties have consistently been **30% of Net Worth** of the company for past five years.
  - Company has allowed some of its related parties to avail Guarantee facilities out of its existing credit facilities. The balance of such guarantees were 240cr in FY18
- Loans taken by its related parties are secured by Company's assets
- Does not mention the names of related parties to whom loans are given and also does not mention the interest rates at which these loans are provided - the duration of these loans are also not mentioned
- **Does not disclose names of Related Parties with which 10% of the transaction has been done, whereas all other companies report.**
- Mostly foreign currency letters of credit of related parties are secured by Company's guarantees.

Auto Co

Key Observations:

- Auto Co Limited has earned an average EBITDA of ~15% of Revenue over the years FY14-18 i.e. Profit attributable to the shareholders before interest , taxes and amortization have yielded only 15%
- On the other hand, the Holding Co has done substantial transactions with the entity which have aggregated almost 60% of the EBITDA as follows
  - Purchases from Holding Co. and fellow subsidiaries controlled by Holding Co form almost 25% of the average EBITDA over FY 14-18
  - Auto Co also pays Royalty to Holding Co which are almost 35% of the EBITDA over FY14-18

- R&D Expenses incurred by the company itself have aggregated 7% of the EBITDA, and hence this continued payment of Royalty to parent is questionable.

- The holding company has also setup business in India in the same line of business as the company

- Moreover Holding Co has in the past also tried to setup a factory in India on its own, through which it intended to sell vehicles to Auto Co, who in turn would sell it to Indian Customers. This move was challenged by the shareholders, especially because Auto Co had cash to setup own plant and was anyways paying royalty and technical fees to Holding Co

Specific Case Studies

Cases related to Related Party Transaction which faced several investor backlash

Royalty Related issues

- **Jubilant Foodworks** – In FY 19, the holding company of Jubilant FoodWorks Ltd.—the operator of Domino's Pizza chain in India—backtracked on charging a royalty from subsidiaries for using its brand name within hours as it sparked concerns about rewarding promoters at the expense of shareholders. The company lost market cap in excess of 1000 Crores, when the holding company made a proposal to charge corporate brand royalty of 0.25 percent of consolidated revenues of the company. https://www.bloombergquint.com/markets/jubilant-foodworks-parent-backtracks-on-royalty-issue

- **Akzo Nobel -** In FY-12, the company proposed to increase Royalty to its Amsterdam-based parent from 1% to 3%. After the proposal was brought for Shareholder approval, some Institutional Shareholders objected to the same vehemently. Eventually company had to partially roll back the proposed royalty from 3% to 2% https://economictimes.indiatimes.com/news/company/corporate-trends/akzo-nobel-india-board-agrees-to-partial-rollback-of-royalty-rate-to-parent/articleshow/11893003.cms?from=mdr

- **Maruti Suzuki –** Shareholders criticized royalty payments by Maruti Suzuki India Ltd to its parent Suzuki Motor Corp after Royalty value increased by around 7 times in 15 years. Shareholders demanded explanation on the basis of charging high royalty https://www.livemint.com/Companies/LiLgaEopbcAsitOhW2sdkK/Suzuki-faces-criticism-over-Maruti-royalties.html

Specific Case Studies

Merger, Acquisition and Sale of Undertaking

- **PTL Enterprise -** The management proposed to sell its entire stake in two hospitals to Promoter Owned entities at very low valuations. The proposal faced strong confrontation from shareholders due to its low valuation. This was the time when Related Party Transactions (RPT) did not require minority shareholders' approval. Large shareholders objected to the deal got a stay against the proposal and finally the sale was stopped. The company had to shelve the plan, and in fact never raised it again. Company proposed the sale of its entire shareholding in two hospitals. https://www.thehindu.com/business/Industry/ptl-bid-to-sell-hospitals-cheaply-draws-flak/article6272847.ece

- **Siemens** *- In FY14, Siemens India agreed to sell its Metal Technologies Business to a whole owned subsidiary of Siemens AG (Parent Co) on a slump sale basis without a proper valuation report . The valuation incidentally was lower than the value at which Siemens India purchased the shares from Siemens AG. Minority Shareholders rejected the resolution as the valuation was below the acquisition price.* ***Siemens had to reconstitute a committee for evaluating the value and thereafter the value was revised 20% upwards*** https://www.vccircle.com/siemens-ups-offer-buy-indian-arms-metals-tech-unit-after-shareholders/

- **Crompton Greaves** – In FY14, Crompton Board approved the demerger of the consumer businesses The demerger came in for flak as Crompton would hold a 25% stake in the demerged consumer goods company, in addition to the holding by the promoter group and minority shareholders. This implied undue gain for the promoters who would hold a stake both directly in the new entity and indirectly through CG. Following shareholder pressure, the company had to tweak the structure to make it fair https://www.livemint.com/Money/ZfQrFG82FvBIVYoe4oeTrM/Crompton-Greaves-improves-demerger-plan-of-consumer-goods-bu.html

Specific Case Studies

Loans, Guarantees and Investments

- **Kesoram** – In FY 18, CFO of the company had to step down after shareholders raised uncomfortable questions at the AGM against the management about how the company's spun pipe business as well as shares worth hundreds of crores were sold to a third party and then later bought back. The shareholders alleged that in the process, Camden Industries, which company had declared not to be a "related party" under Sebi's norms, made pecuniary gains at the cost of minority shareholders https://www.telegraphindia.com/business/kesoram-cfo-steps-down/cid/1665447

- **Vedanta –** In FY 19, Shares of the company fell as much as 20% on the concerns of corporate governance issue after it was reported that a subsidiary of the company invested $200 million in buying a stake in entity called Anglo American. This stake was from Volcan Investments, a family trust of promoter Anil Agarwal – a related party https://www.moneycontrol.com/news/business/comment-investors-fear-vedantas-anglo-american-detour-may-only-be-a-trailer-3490361.html

- **Eveready –** In FY20, the auditors of the company resigned on issues relating inter-corporate deposits and corporate guarantees to promoter group companies. The shares of the company had already fallen by more than 50% in an year due to issues relating to Guarantees and Loans advanced to Debt ridden promoter group companies. https://www.bloombergquint.com/business/pwc-resigns-as-statutory-auditor-for-eveready
- **McLeod Russel India Ltd** – Provisions for deposits of 1,8271cr given to Promoters of the company was not made by the company, thus understating loss. After adjusting its financial statements for it, 1QFY20 loss shot up to 1,826cr vs 4.4cr reported earlier. The company is already undergoing financial difficulties and defaulted on one of its loan in 1QFY20. Deloitte also raised questions over the disclosure of names of all its related parties. https://www.bloombergquint.com/markets/auditor-says-mcleod-russel-understated-loss-by-rs-1822-crore

Specific Case Studies

Salary to Key Management

- **Tata Motors –** In FY15**,** though Motors was making losses , it sought to pay high salaries to KMP beyond the permissible limit. Shareholders voted against the resolution and company, marking the first instance when shareholders successfully stalled payment of excessive compensation to top executives in a company as large as the Tata group firm. Eventually the company had to come back to shareholders with greater disclosures and explanations of why the salary was justified. https://www.livemint.com/Companies/r2bfqMfLmzHLPQzOsJXQwJ/Tata-Motors-shareholders-reject-remuneration-proposals-for-t.html

- **Apollo Tyres –** In FY19, small shareholders defeated a special resolution which had proposed raising the remuneration of Chairman Onkar Singh Kanwar and MD Neeraj Kanwar. Small shareholders were upset at such steep increases in the remuneration at a time when the company wasn't doing well and company had to agree to cap promoter compensation at 7.5% of profit before tax (PBT) and also that the remuneration of chairman Onkar Singh Kanwar and MD Neeraj Kanwar would be lowered by around 30% https://www.financialexpress.com/industry/victory-for-minority-shareholders-in-apollo-tyres-kanwars-to-take-a-30-cut-in-salary/1381109/

- **ITC –** Shareholders objected to company proposal to pay a monthly salary of Rs 1 crore to non-executive chairman Y. C. Deveshwar, especially after he had stepped down from the company https://www.telegraphindia.com/business/concern-over-yogi-pay-package/cid/1476105

Conclusion and views suggested

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- ***Fixed Format*** **-** *Having a Fixed Format for reporting of Related Party transactions which must be adhered to*

- ***Development of Proxy Advisory Firms*** - Shareholders often lack the vigilance to monitor and the determination to contest questionable deals. By working on development of Proxy Advisory Firms, there would be more awareness resulting in nuanced voting

- ***Fairness Opinion:***
- Merely providing value of Related party transactions in Annual Report is of no use in judging the appropriateness of the same
- Beyond a threshold, it should be made mandatory for company to obtain a fairness opinion on the valuation of the transaction from an independent financial adviser, and the opinion should be provided to the shareholders .

- ***Wider Shareholding***
- *As has been observed, Related Party Transactions are higher in companies which are part of a family controlled group*
- *This can be addressed by having more wider shareholding, which would ensure that dominant groups are not able to influence company transactions*
- Though it must be mentioned that wider ownership has its own peril - Where ownership is dispersed, as in the United States, corporate abuses have involved management, instead of promoters or controlling shareholders, and have taken forms such as excessive compensation, stock option re-pricing, and insider trading

- ***Enforcement of Law***
- The implicit argument has been that the real problem with corporate governance in India is a lack of observance and enforcement of the laws, rather than flaws in the law itself.
- *Wherever companies have backtracked from Related Party transactions are those cases where there was backlash from shareholders and loss of market capitalization, rather than from fear of regulatory body.*

Conclusion and views suggested

- ***Sales and Expenses***
  - Beyond a threshold, company to give a justification as to why transactions have been undertaken with Related Parties and why it could not be done from non related entities

- **Royalty**
  - It must be questioned whether there is a need to pay royalty in the first place.
  - Where companies themselves pay for brand development or the company is itself synonymous with the brand, the rationale to pay promoters for the brand must be questioned.
  - More importantly, for recipients of the royalty or brand fee must be able to justify what they are doing to create or develop the brand.For eg in case of Maruti/Nestle, the companies themselves are spending substantial money on R&D and yet they are required to give Royalty on a continued basis to Promoter Group for technology support.

- ***Loans & Advances and Investments :***
  - *Asking Companies to Quantify in the Annual Report - Loans, Advances, Receivables, Investments and Balances **against the net worth periodically**.*
  - *Recommending disclosures on loans dispersed, written- off / provisions made , converted to equity/investments over last 5 years*

- ***Guarantees :***
  - *Asking Companies to Quantify in the Annual Report periodically - Guarantees given and Taken against the net worth*
  - *Widening the scope of guarantees and include capital or revenue commitments, performance guarantees , letters of comforts , letters of credit and pledging of shares during analysis to identify actual financial impact on parent's financials.*
  - ***Asking Companies to Quantify in the Annual Report periodically – The impact on the company if guarantees are triggered***

Conclusion and views suggested

Framing the Approval Resolution

- Framing a statement differently leads to different results
- As of now, all shareholder voting resolutions provide the details of related party and the transaction being entered into.
- However the Audit Committee/Board should provide reasons what are the risks in the related party transactions that are being proposed for voting
- This will not only ensure that Risks are highlighted upfront to the shareholder , which will result in better participation and different voting results

Inherent difficulties in reporting all related-party transactions

- Transactions with related parties are not always easily identifiable
- Auditors rely on management to identify all related parties and related-party transactions. This is ineffectual when the company insider had the prior intent of engaging in a questionable transaction with a related party; to avoid being detected, he or she can simply not disclose the relationship
- Such transactions may not be easily tracked by a company’s internal control
- Questionable independence of independent non-executive directors

References

1. Published Annual Reports from FY 2014 to FY 2018 for specified companies covered under study
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3. SEBI Listing Obligations and Disclosures Requirements Regulations 2015
4. Uday Kotak Committee Report (Recommendations) on Corporate Governance
5. CFA Institute
6. IiAS Research

Thank You