Related Party Transactions: Need for better disclosures

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In the present scenario, related party transactions have become an inevitable part of the business world. A large number of companies in India are under common control of a single parent company or are owned by a particular individual or family which in turn provide them effective control of most companies. Related party transactions are widespread and are significant in value. Entities frequently carry on their business activities through subsidiaries, joint ventures or associates. It has been observed that loans, advances, and guarantees account for a high percentage of net worth of the reporting companies, with subsidiaries and associates constituting the major portion. Therefore, such widespread and significant involvement of related party transactions in the present day business world have necessitated the need to have much wider disclosure requirements to reflect true and fair view for the users of the financial statements.

There is a general presumption that transactions reflected in financial statements are consummated on an arm's length basis between independent parties. However, that presumption may not be valid when related party relationships exist because existence of certain relationships between them may result in transactions being affected at other than arm's length price. Also, related parties may enter into transactions which unrelated parties would not enter into or they may not be effected at the same terms and conditions as between related parties. Sometimes, no price is charged in related party transactions. For example, interest free loan provided by a holding company to its subsidiary or goods are sold or services are provided other than at arm's length price. In fact, even in the absence of any transaction between parties mere existence of a related party relationship between one party may affect transactions with another party. For example, a holding company may refrain its subsidiary from acting because of the control or significant influence that it exercises over its subsidiary. There may be situations where the major source of a subsidiary's income is through its holding company. It might not have any other source of generating income. In view of the aforesaid, the results depicted in the financial statements may not reflect true and fair view of the operations of the reporting enterprise. A related party relationship could have an effect on the financial position and operating results of the reporting enterprise. Therefore, information about such relationships and transactions is useful to users of financial statements, who would be able to evaluate its significance over the results depicted in the financial statements.

Currently, in India, Accounting Standard (AS) 18, *Related Party Disclosures,* establishes the requirements for disclosure of related party relationships as well as the transactions between a reporting enterprise and its related parties. These requirements apply to the financial statements of each reporting enterprise and to the consolidated financial statements presented by a holding company. Generally, the statute governing an enterprise requires disclosure of transactions with certain categories of related parties. Specifically, attention is focused on directors and their relatives, since the fiduciary nature of their relationship with the enterprise, renders the disclosures of transactions with them very important in order to arrive at the 'true and fair view' for the users of financial statements.

For the purpose of better disclosures, AS 18 requires disclosure of the name of the related party and nature of the related party relationship where control exists irrespective of whether or not there have been transactions between the related parties. AS 18 further requires that in case of transactions between related parties, during the existence of a related party relationship, the following disclosures are to be made:

(i) the name of the transacting related party
(ii) a description of the relationship between the parties
(iii) a description of the nature of transactions
(iv) volume of transactions either as an amount or as an appropriate proportion
(v) any other elements of the transaction necessary for understanding of financial statements
(vi) the amounts or appropriate proportions of outstanding items together with the provisions for doubtful debts due from such parties at the balance sheet date
(vii) any amounts written off or written back in the period in respect of debt due from or to related parties.

However, it may be a point of consideration that even though stringent disclosures are required by the Standard, yet various instances have been noticed in the published accounts of listed companies, wherein the requirements of the Standard have not been followed in the right spirit or have not been followed at all.

In some cases, the guarantees given on behalf of a subsidiary company were not disclosed as part of the related party information. As required by the Standard, 'guarantees and collaterals' constitute related party transactions and hence guarantees given on behalf of a subsidiary company would need to be disclosed. Though, the Standard permits disclosure of details of transactions with individual related parties in aggregate by type of related party so that in case of voluminous transactions, such may be easily understood, it precludes their disclosure in such a way so as to obscure the importance of significant transactions. Hence, purchases or sales of goods should not be aggregated with purchases or sales of fixed assets. Further, simply disclosing the transaction without mentioning the name of the related party with whom such transaction has been conducted is not in accordance with the Standard. In few other cases, it was observed that transaction details of more than 10% of total related party transactions of the same type as required by AS 18 were not disclosed.

These observations imply that in order to achieve transparency in annual accounts, the disclosure requirements of the existing AS 18 should be applied in its true spirit. This is particularly true in the context of the contemporary business environment since the Revised Schedule VI to the Companies Act, 1956, also requires related party transactions, particularly in the case of current/non-current loans and advances as well as other receivables and payables, to be shown separately from other items in the same category for more transparent disclosures. In today's world of numerous business dealings, those with related parties have to be disclosed in the letter and spirit of the Standard to give the readers of accounts an informed picture of the dealings with related parties. Further, in this era of globalization, when the world is moving towards more transparent disclosures, Indian companies need to pull up their socks and come out with better related party disclosures in their published financial statements.

Further, it is worthwhile to note that IFRS-converged Indian Accounting standard on the subject, i.e., Ind AS 24, *Related Party Disclosures,* is wider in its scope and has covered certain more disclosures in its ambit. In this regard, it may be noted that Paragraph 3(a) of AS 18 covers transactions with fellow subsidiaries, transactions between an entity and its associate or an entity and its joint venture as related party transactions but it does not include transactions between co-associates or with entities under joint control of a common entity. For example, A limited has joint control over B limited and C limited. Under the existing AS 18 norms, transactions between an entity and its associate or joint venture (i.e. those forming direct relationships) only are covered. Hence, B and C limited are related parties for A limited due to existence of direct relationship as per paragraph 3(a), while B limited and C limited are not related to each other since AS 18 covers only direct relationships. However, this aspect is covered in Ind AS 24. Ind AS 24 specifically covers transactions with (i) entities under joint control of a third party and (ii) one entity being an associate and other being joint venture of a third party to be included under the scanner of related party disclosures. Since, the logic behind inclusion of such transactions is that the existence of an indirect relationship between them (viz. B and C limited) via a third party (viz. A limited) (i.e. the holding entity in case of fellow subsidiaries or venturer entity in case of joint venture) might lead to transactions being affected at other than arm's length price. Thus, inclusion of the aforesaid transactions in Ind AS 24 seems to be appropriate. However, Ind AS 24 still excludes entities indirectly related via a third party by way of significant influence or key management personnel only. To illustrate, let us say an entity A exercises significant influence over entity B and entity C or both these entities have a key management personnel in common. Ind AS 24, describes that for entities to be related to each other, there must exist control or joint control through reporting entity for both of them or at least for one of them. In the instant case, control or joint control is not present even in one leg of the relationship, therefore Entity B and Entity C will not be related to each other.

The related party relationships covered under existing AS18 in the context of key management personnel and its relatives with the reporting entity are limited as compared to Ind AS 24. AS 18 covers spouse, son, daughter, brother, sister, father and mother of the key management personnel in the definition of 'relatives', whereas, Ind AS 24 covers more relations under its ambit, as it uses the term 'a close member of that persons family' which includes the persons specified within the meaning of 'relative' under the Companies Act, 1956 and that person's domestic partner, children of that person's domestic partner and dependants of that person's domestic partner. Moreover, it includes key management personnel of the parent entity as well. Hence, the definition as per Ind AS 24 is wider.

Disclosures for compensation of key management personnel as per Ind AS 24 are comparatively more detailed as these have been bifurcated in different categories viz. short term employee benefits, post-employment benefits, other long term benefits, termination benefits and share-based payments. In the absence of these detailed disclosures, the users are unable to identify what perquisites or any other benefits in the name of remuneration are being provided to the Key Management Personnel.

Disclosure requirements under Ind AS 24, inter alia, include the amount of outstanding balances, including commitments and their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement.

The aforesaid disclosure requirement regarding terms and conditions and details of guarantee are additional disclosures under Ind AS 24 compared to AS 18. For example; A Ltd. (Holding co.) provided a loan of Rs. 5 crores to B Ltd. (entity over which director of A Ltd.

exercises significant influence) at below market interest rate of say (3%) without security. Under Ind AS 24, in addition to the fact that a loan of 5 crores has been provided to B Ltd., there would be disclosures with regard to the rate of interest, tenure of loan, whether secured or not etc. These further disclosures would help the investors to evaluate the fairness of the transactions and will help them in making an informed investment or voting decisions with respect to the company.

The other few disclosure requirements as per Ind AS 24 are also much detailed compared to AS 18. For instance, Ind AS 24 requires an additional disclosure of the name of the next most senior parent which produces consolidated financial statements for public use. Further, Ind AS 24 in relation to disclosure of a related party transaction requires the amount of the transactions to be disclosed, whereas existing AS 18 provides an option to disclose the volume of the transactions either as an amount or as an appropriate proportion.

Considering the above, it may be concluded that although existing AS 18 requires various disclosures but when compared to international standards it is felt that to achieve greater transparency, disclosure requirements with regard to related party transactions may be improved through wider disclosures as laid down in IFRS- converged Ind AS 24. This will also place us at equal footing with the international practices and will improve fairness and efficiency of the Indian capital markets as well.