



The 2008 Asian Roundtable on Corporate Governance

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BACKGROUND DOCUMENT

Hong Kong, China
13-14 May 2008

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INDIA: NATIONAL EXPERIENCE WITH MANAGING RELATED PARTY TRANSACTIONS

1.0 Related party transactions – the Indian perspective

1.1 Like anywhere else in the world, Related party transactions (RPTs) are a normal feature of commerce and business in India. Such transactions are recognised by law to permit flexibility in business and make room for private contractual arrangements and entrepreneurship. Although checks and balances have been provided in law, their enforcement remains a matter of concern in India where relationship based systems - a typical characteristic of Asian countries, are usually far more important than the explicit arm's length systems of corporate governance and contracts observed in some OECD countries.¹ For the controlling shareholders and insiders, such as managers, RPTs can become the mechanism for extracting private benefits at the cost of the other shareholders. The existing legal and regulatory provisions need a review to check abusive RPTs. Dr. J.J. Irani Expert Committee on Company Law has made useful recommendations to address some concerns. A dedicated study of issues concerning RPTs would be useful in identifying the policy steps required to be taken to address the problems concerning RPTs.

1.2 RPTs in India take a somewhat different form from that of other countries. Indian enterprises refrain from direct transactions with the top management because of stringent legal framework. Transactions are generally routed through entities indirectly controlled by promoter group or management. India has one of the largest corporate base in the world, with over 0.7.5 million registered companies. India also has the largest number of listed companies in the world.² The market cap of the companies listed on the Bombay Stock Exchange stands at Rs.53.09319 trillion for the fiscal ending 31 March, 2008. Many of these companies have a large number of subsidiaries, or to such subsidiaries having further subsidiaries. The creation of subsidiaries for separate manufacturing entities, joint ventures, etc. is a business reality. Enterprises frequently carry on separate parts of their activities through subsidiaries or associates and acquire interests in other enterprises for investment or trading reasons. Such interests are acquired in sufficient proportions so that the investing enterprise is able to control or exercise significant influence on the financial and/or operating decisions of its investee. With almost two-thirds of the top 500 Indian companies being group-affiliated, issues relating to corporate governance in business groups are an important issue.

1.3 Founders of companies and families owning the business tend to keep a disproportionate share of control. Where such companies deal with subsidiaries and associate companies, the possibilities of dominant shareholders indulging in RPTs is higher. A study of shareholding patterns in India reveals a marked level of concentration in the hands of the promoters.³ Institutional investors comprising government sponsored mutual funds and insurance companies, banks and development financial institutions (which are also

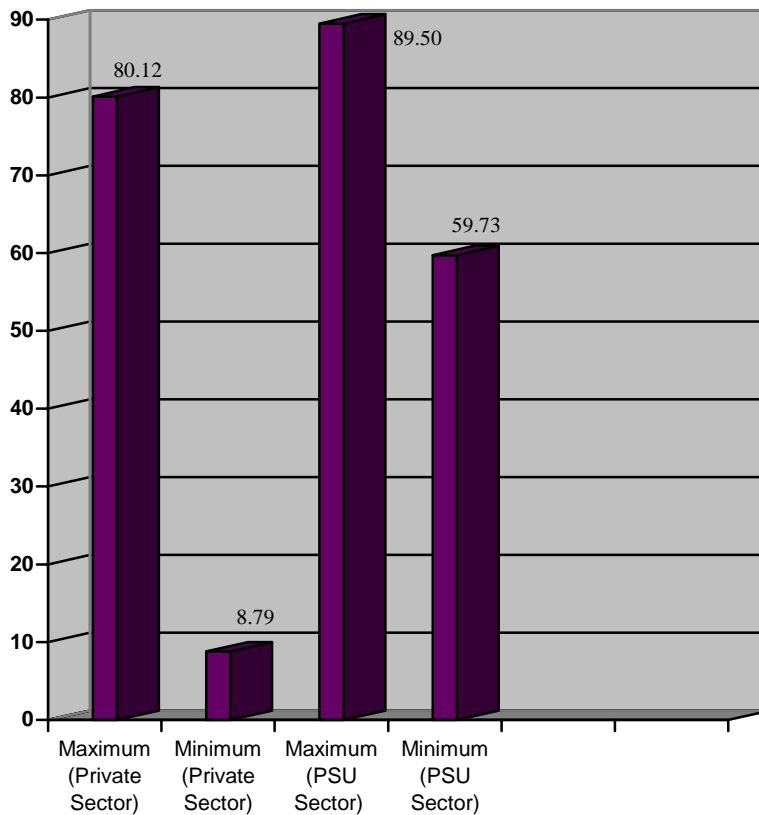
¹ Rajesh Chakrabarti, William L. Megginson and Pradeep K. Yadav, *Corporate Governance in India* (2007)

² The number of companies listed on Bombay Stock Exchange as on February 2008 is 4888 and on National Stock Exchange is 1319.

³ A study conducted by Jayati Sarkar and Subrata Sarkar in 2005 reveals that promoters held 47.74% of the shares in a sample of almost 2500 listed manufacturing companies, and held 50.78% of the shares of group companies and 45.94% of stand-alone firms (*Refer: Jayati Sarkar and Subrata Sarkar, 2005a, "Multiple Board Appointments and Firm Performance in Emerging Economies: Evidence from India," Working Paper 2005-001, Indira Gandhi Institute of Development Research, Mumbai, India.*)

long-term creditors), and foreign institutional investors hold over 22% shares of the average large company in India. Of these, the share of mutual funds, banks and development financial institutions, insurance companies, and foreign institutional investors are about 5%, 1.5%, 3% and 11%, respectively. A study conducted in 2007 shows the average shareholding of promoters in Indian companies is 80.12% (Refer: Graph 1).⁴ This imbalance between the ownership and control often creates opportunities for practice of transferring money or assets from the company to a dominant corporate owner, manager or director. The firms that receive unexpectedly high earnings have been found to channel the extra cash disproportionately to the controlling family.⁵

Graph: 1



Source: Mahendra & Ardneham, Corporate Governance Research Report, 2008

1.4 Tunnelling or the transfer of assets and profits out of firms for the benefit of those who control them is a serious concern in business groups with pyramidal ownership structure and inter-firm cash flows.⁶ The controlling shareholders are able to sustain the business shocks as the entities lower down in the pyramid take most of the shock thus hurting the minority shareholders. There is some evidence that firms associated with business groups have superior performance than stand-alone firms.⁷ Using data for Indian firms in 385 business groups in 2002-03 and 384 groups in 2003-04, a study conducted by

⁴ Mahendra & Ardneham Consulting Private Limited

⁵ Bertrand, Mehta, and Mullainathan 2002

⁶ S. Johnson, R. Laporta, and S. Mullainathan, 2002 “Ferretting out Tunneling: An Application to Indian Business Groups,” *Quarterly Journal of Economics* 117, pp.121-48

⁷ Rajesh Chakrabarti, William L. Megginson and Pradeep K. Yadav, *Corporate Governance in India (2007)*

Raja Kali and Jayati Sarkar in 2007 finds that firms with greater ownership opacity and a lower wedge between cash flow rights and controls than those in a group's activity are likely to be located away from the core activity. This incentive for tunneling explains the persistence of value destroying groups in India and occasional heavy investment by Indian groups in businesses with low contribution to group profitability.⁸ A study of corporate governance in India conducted by Rajesh Chakrabarti (Indian School of Business, Hyderabad), William L. Megginson and Pradeep K. Yadav (University of Oklahoma) refers to a study by Jayashree Saha using a sample of over 600 of the 1000 largest (by revenues) Indian firms in 2004, which states that, after controlling for other corporate governance characteristics, firm performance is negatively associated with the extent of RPTs for group firms but positively so for stand-alone companies. This further strengthens the circumstantial evidence of tunneling and its adverse effects. The same study also reveals that, using a sample of over 5000 firms (listed or not?) for the period 2003-2005, most RPTs in India occur between the firm and "parties with control," as opposed to management personnel as in the United States. Also, group companies consistently report higher levels of RPTs than stand-alone companies.

1.5 At the same time, a number of Indian companies having high percentage of promoter shareholding who exercise significant control over management run the business with high standards of governance including in respect of RPTs. Companies like Wipro with 79.58% promoter holding, TCS with 80.12%, Bharti Airtel with 44.33%, Bajaj Auto with 30.11% and Hindalco with 31.4% holdings, are some of the well-governed companies despite the fact that families have dominant shareholding in these companies belying the perception that companies with high concentration of promoter shareholding tend to indulge in RPTs.⁹

1.6 There is no specific data available in the public domain on the number of RPTs in India. However, according to a Survey conducted in 2006, there are a lot of RPTs in India.¹⁰ In response to the question circulated to companies as part of the survey asking them to quantify RPTs as a percentage of sales, 142 companies (67% of the respondents) reported that RPTs were 1% of revenue or greater, and 42 companies (20% of the respondents) reported that RPTs were 5% of revenues or greater (*Refer: Table 1*). For these 42 firms, the mean (median) level of RPTs was 16% (10%) of sales.

1.7 The compliance rate of arms-length policy appears to be fairly high. Clause 49¹¹ requires the audit committee to approve all RPTs and requires the firm to disclose "materially significant" RPTs to shareholders. Here was an impressive rate of compliance of arms-length policy (*Refer: Table 1*). 78% of the firms that participated in the survey questionnaire stated they had policies requiring RPTs to be on arms-length terms.¹²

Table 1: Related Party Transactions

Table shows number of Indian firms (% of responding firms) with the indicated characteristic for RPTs. Sample is 301 Indian firms which responded to the India CG Survey 2006. Number

⁸ See Raja Kali and Jayati Sarkar, 2007, "Diversification and Tunelling: Evidence from Indian Business Groups,"

⁹ *Mahendra & Ardneham*, Corporate Governance Research Report, 2008

¹⁰ N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008)

¹¹ This clause provides for the corporate governance norms to be complied by listed companies in India, and appears in the listing agreement signed by the listed companies. The clause is prescribed by the Securities and Exchange Board of India.

¹² N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008)

of missing or ambiguous responses ranges from 5 to 67. Percentages are of firms with usable responses.

Characteristic	Required	Firms with characteristic	Mean (median)
RPTs disclosed to shareholders	(2004)	275 (94%)	
Firm requires RPTs to be on arms-length terms		230 (78%)	
Company has outstanding loan(s) to insider(s)	(1956)	20 (7%)	
Company rents real property to or from insider		50 (20%)	
RPTs are >1% of revenues		142 (67%)	
RPTs are >5% of revenues		42 (20%)	16% (10%)
Board reviewed at least one RPT in last year		107(60%)	14(6)
Board reviewed at least 5 RPTs in last year		63 (36%)	

Source: *N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008):*

2.0 Public Disclosures

2.1 **India has a fairly stringent regime for regulating RPTs through a number of legal provisions.** This includes a well defined regime for disclosure of RPTs. The Companies Act, 1956 (Companies Act) provides a comprehensive framework for disclosure and approvals of RPTs. These provisions are discussed in some detail in the later section of the paper. Clause 49 of the listing agreement entered by listed companies with stock exchange provides for further requirements for disclosure and approval of RPTs.¹³ The relevant provisions of Clause 49 are also discussed in the later part of this paper. The Accounting Standard (AS) 18 prescribed by the Institute of Chartered Accountants of India (ICAI) is applied in reporting RPTs and transactions between a reporting enterprise and its related parties. AS 18, among others, makes reporting of RPTs by Indian companies mandatory. The requirements of this Standard apply to the financial statements of each reporting enterprise and the consolidated financial statements presented by a holding company. The Income Tax Act, 1961 deals with transactions between related parties from transfer pricing perspective. Some other laws, regulations and practices also deal with RPTs. These are discussed in later part of this paper.

2.2 **The words, ‘related parties’ and ‘related party transactions’ are defined in AS 18.** Before discussing the highlights of the legal regime dealing with the RPTs it would be imperative to discuss the meaning and scope of these two critical words.

Who are ‘Related Parties’?

2.3 **The 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 control over the other party in making financial and/or operational decisions.**¹⁴ AS 18 excludes

¹³ The provisions of Clause 49 have been provided by Securities and Exchange Board of India

¹⁴ Paragraph 10.1 of AS 18

certain parties from being treated as related parties, and the following are deemed not to be “*related parties*”:

- Simply because the two companies have a director in common unless such director is able to affect the policies of both companies in their mutual dealings. This is notwithstanding the following provisions of AS 18 which describe the related party relationships:
 - (i) Key management personnel and relatives of such personnel (Note: Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. In the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel. A non-executive director of a company is, however, not considered as a key management person under AS 18 by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. The requirements of AS 18 are not applied in respect of a non-executive director, unless he falls in any of the categories in paragraph 3 of AS 18.)¹⁵
 - (ii) Enterprises over which any key management personnel and relatives of such personnel or individuals owning, directly or indirectly, any interest in voting power of reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise
- A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and
- The following parties, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
 - providers of finance;
 - trade unions;
 - public utilities;
 - government departments and government agencies including government sponsored bodies.”

2.4 In nutshell, RPTs can be in respect to holding companies, subsidiaries and fellow subsidiaries; associates and joint ventures; individuals owning, directly or indirectly, an interest in the voting power that gives them control or significant influence over the enterprise. It also includes relatives of any such individual; key management personnel and relatives of such personnel and enterprises over which any individual or key management personnel are able to exercise significant influence. Two companies, simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings), are not considered to be related parties. Also a single customer,

¹⁵ Paragraph 10.8 read with paragraph 14 of AS 18

supplier, franchiser, distributor, or general agent with whom significant volume of business is transacted cannot be regarded as a related party. Similar is the case of providers of finance, trade unions, public utilities and government departments and government agencies including government sponsored bodies in the course of their normal dealings with an enterprise.

Who ‘Related Party Transactions’?

2.5 A **‘related party transaction’ is a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.**¹⁶ AS18 applies to with the following related party relationships only:

- Enterprises that directly, or indirectly, through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise. This includes holding companies, subsidiaries and fellow subsidiaries;
- Associates¹⁷ and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
- Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual. (A ‘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.¹⁸);
- Key management personnel and relatives of such personnel; and
- Enterprises over which any individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual or key management personnel and relatives of such personnel is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

2.6 **Certain disclosures are exempted from the applicability of AS 18.** These include:

- Disclosures of information which would conflict with the reporting enterprise’s duties of confidentiality in terms of a statute or by any regulator or similar competent authority.
- No disclosure is required in consolidated financial statements in respect of intra-group transactions.
- No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

¹⁶ Paragraph 10.2 of AS 18

¹⁷ According to AS18, an ‘associate’ is an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

¹⁸ Paragraph 10.9 of AS 18

- Where there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, According to paragraph 17 of AS 18, the operating results and the financial position of an enterprise may be affected by a related party relationship even if RPTs do not occur. The mere existence of the relationship itself may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another. For example, a subsidiary may be instructed by its holding company not to engage in research and development. Because there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, it is provided by AS 18 that disclosure of such effects may not be required.

2.7 **“Control” and “significant influence” form the key principle in RPTs covered by AS 18.** The ‘control’ is defined as (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise. ‘Significant influence’ means participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

2.8 **Thus, an enterprise is considered to control the composition of the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company.** An enterprise is deemed to have the power to appoint a director if any of the following conditions is satisfied:¹⁹

- A person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or
- A person’s appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or
- The director is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

2.9 **An enterprise is considered to control the composition of the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise.** An enterprise is deemed to have the power to appoint a member if any of the following conditions is satisfied:²⁰

- A person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or
- A person’s appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or
- The member of the governing body is nominated by that other enterprise.

¹⁹ Paragraph 11(i) of AS 18

²⁰ Paragraph 11(ii) of AS 18

2.10 An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20% or more interest in the voting power of the enterprise.

2.11 AS 18 notes that significant influence may be exercised in several ways. Significant influence may be gained by share ownership, statute or agreement. If an investing party holds, directly or indirectly through intermediaries, 20% or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investing party holds, directly or indirectly through intermediaries, less than 20% of the voting power of the enterprise, it is presumed that the investing party does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.²¹ Significant influence may be exercised by:

- representation on the board of directors
- participation in the policy making process
- material inter-company transactions,
- interchange of managerial personnel, or
- dependence on technical information.

Disclosure of information to public: requirement of AS18

2.12 While the Companies Act requires disclosure in financial statements of transactions with certain categories of related parties, AS 18 provides for disclosure of 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. It further notes that where the reporting enterprise controls, or is controlled by, another party, the disclosure of the related party and nature of the related party relationship is relevant to the users of financial statements irrespective of whether or not transactions have taken place with that party. Existence of control relationship may prevent the reporting enterprise from being independent in making its financial and/or operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an enterprise's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the enterprise's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.²²

2.13 The following examples of the related party transactions are provided in AS18 in respect of which disclosures may be made by a reporting enterprise:

- Purchases or sales of goods (finished or unfinished);
- Purchases or sales of fixed assets;
- Rendering or receiving of services;
- Agency arrangements;
- Leasing or hire purchase arrangements;
- Transfer of research and development;

²¹ Paragraph 13 of AS 18

²² AS 18

- Licence agreements;
- Finance (including loans and equity contributions in cash or in kind);
- Guarantees and collaterals; and
- Management contracts including for deputation of employees.

2.14 **Where transactions between related parties take place, during the existence of a related party relationship, the reporting enterprise is required to make certain disclosures.** These include the following²³:

- The name of the transacting related party;
- A description of the relationship between the parties;
- A description of the nature of transactions;
- Volume of the transactions either as an amount or as an appropriate proportion;
- Any other elements of the related party transactions necessary for an understanding of the financial statements (For example: An indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.)
- The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- Amounts written off or written back in the period in respect of debts due from or to related parties.

2.15 **Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.** This is because disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. However, this should not be done in such a way as to obscure the importance of significant transactions. For example, purchases or sales of goods are not to be aggregated with purchases or sales of fixed assets. Nor can a material related party transaction be clubbed with an individual party in an aggregated disclosure. Materiality would primarily depend on the facts and circumstances of each case.

2.16 **In deciding whether an item or an aggregate of items is material, the nature and the size of the item(s) may be evaluated together.** Depending on the circumstances, either the nature or the size of the item could be the determining factor for deciding if the item is material. As regards size, for the purpose of applying the test of materiality, ordinarily a related party transaction involving an amount which is in excess of 10% of the total related party transactions of the same type (such as purchase of goods), is considered material. However, if facts and circumstances of a particular case so demonstrate even a transaction of less than 10% can be construed as material. As regards nature, ordinarily the related party transactions which are not entered into in the normal course of the business of the reporting enterprise are considered material subject to the facts and circumstances of the case.

Difference between AS18 and IAS24

2.17 **AS 18 is largely similar to IAS 24. The Accounting Standards Board in India while formulating Accounting Standards gives due consideration to the International Accounting Standards and try to integrate them to the possible extent.** A few differences are however, to be noted in the two, largely due to the peculiar dynamics that exist in the country. Some of the notable differences are discussed in this paragraph. IAS 24 excludes the two companies having a director in common from the definition of related parties, AS 18,

²³ Paragraph 23 of AS 18

while providing such exclusion specifically qualifies that such exclusion would not apply if such director is able to affect the policies of both companies in their mutual dealings. IAS 24 provides that a party is related to an entity if the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity. However, AS 18 does not include such a relationship. AS 18 read with Accounting Standard Interpretation-18 excludes non-executive directors from the definition of key management persons by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. On the other hand, key management personnel under IAS 24 include non-executive directors too. AS 18 describe the relatives of an individual, viz., spouse, son, daughter, father, mother, brother and sister. However, IAS 24 does not state clearly as to who are the ‘close members of the family’.²⁴ A brief summary of the differences between AS 18 and IAS 24 is provided in *Table 2*:

Table: 2 Key differences between AS18 and IAS24

	AS 18	IAS 24
1.	Excludes non-executive directors from the definition of key management personnel by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise	Key management personnel under IAS 24 include non-executive directors.
2.	Does not provide any exemption in case of disclosure requirements. Accordingly, the financial statements of holding and subsidiary would be self-contained.	No disclosure of transactions is required in parent financial statements when they are made available or published with the consolidated financial statements; and in financial statements of a wholly-owned subsidiary if its parent is incorporated in the same country and provides consolidated financial statements in that country
3.	Does not require the disclosures in circumstances where making disclosures as per the requirements of the standard would conflict with the duties of confidentiality of the reporting enterprise as specifically required in terms of a statute or by any regulator or similar competent authority.	IAS 24 is silent in this regard.
4.	The definition of the term ‘related party’ provides that 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.	The definition of ‘related party’ as per IAS 24 does not include the expression ‘at any time during the reporting period’ .
5.	AS 18 clearly state the relatives of an individual, viz spouse, son, daughter, father,	However, IAS 24 does not state clearly as to who are the ‘close members of the

²⁴ <http://rbidocs.rbi.org.in/rdocs/PublicationReport/docs/18353.doc>

	mother, brother and sister.	family.
6.	Recognises one more situation in the definition of 'control', i.e. control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise.	Defines control as ownership, directly, or indirectly through subsidiaries, of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise.

2.18 **The ICAI which is the equivalent of AICPA in U.S has announced that it will bring its accounting standards in line with the International Financial Reporting Standards from 2011.** India is a growing economy and such moves will help in comparing financial statements across boundaries. Further the ICAI plans to begin training chartered accountants across India in how to apply the international accounting standards.²⁵

Public disclosure of related party transaction: requirements of Clause 49

2.19 **Besides AS 18, provisions for public disclosure by listed companies are prescribed in Clause 49.** The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a management discussion and analysis section in the annual report discussing general business conditions and outlook; and (vii) background and committee memberships of new directors as well as presentations to analysts.

Disclosure to shareholders

2.20 **Clause 49 requires disclosure of the basis of related party transactions.** It provides for the disclosure of the following information related to RPTs:

- A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee;
- Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee; and
- Details of material individual transactions with related parties or others, which are not on an arm's length basis, should be placed before the audit committee, together with management's justification for the same.

2.21 **A separate section on corporate governance is required to be provided in the annual reports of company, with a detailed compliance report on corporate governance.** It further requires that non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is provided in Annexure IC and list of non-mandatory requirements is given in Annexure ID to Clause 49. These are attached as *Appendix A and Appendix B*, respectively with this paper. The companies are also required to submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure IB.

²⁵ <http://www.webcpa.com/article.cfm?articleid=24922>

The report is required to be signed either by the compliance officer or the chief executive officer of the company. A format of the report is attached as *Appendix C*.

Compliance Certificate

2.22 To make disclosure reliable and credible, it is provided by Clause 49 that the company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in Clause 49 and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the stock exchanges along with the annual report filed by the company. The non-mandatory requirements given in Annexure ID may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance)/non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the annual report.

2.23 Securities and Exchange Board of India (SEBI) has introduced a rigorous regulatory regime to ensure fairness, transparency and good practice. For example, for greater transparency, SEBI has mandated disclosure of all transactions where the total quantity of shares is more than 0.5% of the equity of the company. Brokers must disclose to the stock exchange, immediately after trade execution, the name of the client and other trade details, and the exchange must then disseminate this information to the general public on the same day. The new environment of improved transparency, fairness, and efficient regulation led Bombay Stock Exchange (BSE) to also become a transparent electronic limit order book market in 1996, with an efficient trading system similar to the National Stock Exchange (NSE). Equity and equity derivatives trading in India has skyrocketed to record levels over the last ten years.

2.24 Clause 49 requires the chief executive officer and the chief financial officer or their equivalents to sign off on the company's financial statements and disclosures and accept responsibility for establishing and maintaining effective internal control systems. The company is also required to provide a separate section of corporate governance in its annual report, with a detailed compliance report on corporate governance. It should also submit a quarterly compliance report to the stock exchange where it is listed. Finally, it needs to get its compliance with the mandatory specifications of Clause 49 certified by auditors or by practicing company secretaries. In addition to these mandatory requirements, Clause 49 also mentions non-mandatory requirements concerning the facilities for a non-executive chairman, the remuneration committee, half-yearly reporting of financial performance to shareholders, moving towards unqualified financial statements, training and performance evaluation of board members, and perhaps most notably a clear "whistle blower" policy.

2.25 In practice, for transactions with an inside director, approval by non-conflicted directors is uncommon and approval by non-conflicted shareholders is rare (two firms). Approval requirements are similar for transactions with a controlling shareholder.²⁶ (*Refer: Table 3*).

²⁶ N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008)

Table 3: Approval Requirements for Related Party Transactions

Table below shows number of Indian private firms with the indicated approval requirement for related party transactions (RPTs) with specified counterparties. Sample is 301 Indian private firms which responded to the India CG Survey 2006.

Nature of RPT approval	With inside director	With controlling shareholder
No specific requirement	81	102
Approval by audit committee	96	82
Approval by board of directors	212	182
Approval by shareholders	37	44
Approval by non-conflicted directors	26	20
Approval by non-conflicted shareholders	2	3

Source: N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008)

3.0 Board Approval

Consent of the board

3.1 **The consent of the board of directors is required for contracts for sale, purchase or supply of goods, material or services. The consent is also required for underwriting the subscription of any shares in, or debentures of, the company, with the company by a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director.**²⁷ In case of a company having a paid-up share capital of not less than ten million rupees, no such contract can be entered into except with the previous approval of the central government. It is also a function of the board that it monitors and manages potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.²⁸

Consent of board not required in some cases

3.2 **The Companies Act exempts certain classes of contract from obtaining consent of the board.** These are:

- The purchase of goods and materials from the company, or the sale of goods and materials to the company, by any director, relative, firm, partner or private company as aforesaid for cash at prevailing market prices. However, such contract or contracts should not relate to goods and materials the value of which, or services the cost of which, exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract or contracts.
- Any contract or contracts between the company on one side and any such director, relative, firm, partner or private company on the other for sale, purchase or supply of any goods, materials and services in which either the company or the director, relative, firm, partner or private company, as the case may be, regularly trades or does

²⁷ Section 297 of the Companies Act, 1956

²⁸ Corporate Governance in India: Theory and Practice, National Foundation for Corporate Governance (2004)

business. However, such contract or contracts should not relate to goods and materials the value of which, or services the cost of which, exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract or contracts.

- In the case of a banking or insurance company, any transaction in the ordinary course of business of such company with any director, relative, firm, partner or private company as aforesaid.

3.3 The provisions of the Companies Act do not clearly provide if the consent of the board is required for sale or purchase as also lease of immovable property. Although the word “goods” is used in section 297 in the Companies Act, the word itself is not defined. If one were to apply the definition of “goods” provided under the Sale of Goods Act, 1930, the effect would be no consent of board is required for sale of immovable properties. This is because the word “goods” in Sale of Goods Act, 1930 means every kind of movable property. However, if the plant or machinery is not permanently attached to the earth, it may fall in the category of goods within the meaning of the section. According to a clarification provided by the Ministry of Corporate Affairs (MCA), Government of India (GOI), a director owning premises entering into a contract of tenancy with the company or giving on hire to the company any plant or machinery owned by him does not require any consent of the board.²⁹ In practice, most interested parties however, do obtain consent of the board even though it could be argued that such requirement is not obligated by law.

3.4 It appears that the provisions of the Companies Act are not designed to apply to appointments of managing directors, etc. The contracts covered by the Companies Act include any contracts involving some value. Contracts for supply of services are also included. Services do not bear any specific definition though some of their instances can be cited, like banking, finance, insurance, transport, advertising, warehousing, purveying of news or information, etc. But service contracts do not include those for personal services, such as a contract for employment. This is evident from the general scheme of the Companies Act which provides another sanction in section 314 to cover such contracts. There is a reference to the market value of the services in the relevant section of the Companies Act, which also suggests personal service contracts are excluded.³⁰ Even according to the MCA, the ‘supply of service’ is not the same as ‘rendering of personal services’.³¹ The provisions of the Companies Act do not deal with the indirect interest of a director, even though it may be substantial and real.

3.5 Disclosure is required to members of directors’ interest in contract appointing manager, managing director.³² The Companies Act provides disclosure in following cases:

- Where a company enters into a contract for the appointment of a manager of the company, in which any director is, directly or indirectly, concerned or interested; or varies an existing contract in which a director is concerned or interested; the company is required to send to every member of the company an abstract of the terms of the contract or variation. This should be accompanied with a memorandum clearly specifying the nature of the concern or interest of the director in such contract or variation. This has to be done within 21 days from the date of entering into the contract or of the varying of the contract, as the case may be;

²⁹ Clarification provided by Department of Company Affairs by Letter No. 9/41/90-CL-X dated 27.3.1990

³⁰ Guide to Companies Act, A Ramaiya (2004)

³¹ Circular No. 13/75 dated 5.6.1975, Ministry of Corporate Affairs

³² Section 302 of the Companies Act, 1956

- In case where a company enters into a contract for the appointment of a managing director of the company, or varies an existing contract, the company is required to send an abstract of the terms of the contract or variation to every member of the company. If any other director of the company is concerned or interested in the contract or variation, a memorandum clearly specifying the nature of the concern or interest of such other director in the contract or variation is also required to be sent to every member of the company with the abstract aforesaid. This has to be done within 21 days from the date of entering into the contract or of the varying of the contract, as the case may be;
- In case a director becomes concerned or interested in any such contract as is referred above after it is made, the abstract and the memorandum shall be sent to every member of the company within 21 days from the date on which the director becomes so concerned or interested.
- These provisions apply to cases where any director becomes interested in the appointment of a manager or managing director, after the appointment has been made. If, during the period of office of a manager, or managing director, a person concerned or interested in the manager or managing director becomes a director, the disclosure related provisions must be complied with.
- The provisions also apply to a whole time director though he may not be a managing director. Whole-time director means a director who is in the whole-time employment of the company, like any other full time employee. A director employed part-time does not come under this section.

Prior and post-approval

3.6 Although not expressly provided in the Companies Act, consent of the board must be prior. In circumstances of urgent necessity, a contract with the company for the sale, purchase or supply of any goods, materials or services, may be entered without obtaining the prior consent of the board. However, in such case, the consent of the board must be obtained at a meeting within three months of the date on which the contract was entered into. The consent of the board in such case must be obtained expressly within three months and there can not be any deemed consent merely because a meeting is not held within three months. The consent of the board must be accorded by a resolution passed at a physical meeting of the members of the board. Consent can not be granted by passing a resolution by circulation. The consent contemplated by law is not a general consent but consent referable to each particular or specific contract or contracts. It is important to provide relevant information as any such consent would require knowledge of the necessary facts.

Consequence of non-accord of consent

3.7 If consent is not accorded by the board to any contract, anything done in pursuance of the contract shall be voidable at the option of the board. Some other consequences of non-compliance of RPTs related provisions are discussed in the later section of this paper.

3.8 Indian Company Secretaries Institute (ICSI) has prescribed the best practices in this regard for its practitioner and in-house (employed company secretaries) members. The best practices include a check-list for the company secretaries to ensure that legal provisions and corporate governance best practices on RPTs have been taken into account while certifying on behalf of the company.

Inspection and copies

3.9 All contracts entered into by a company for the appointment of a manager or managing director are open to inspection by members. Such record is required to be kept at the registered office of the company. Any member may obtain an extract and copies thereof may be required by any such member.

Consequences of non-compliance

3.10 The non-compliance of disclosure provisions attracts serious consequences. These consequences are set out as under:

- Default in compliance with the disclosure provisions is punishable with fine. The company, and every officer of the company who is in default, shall be punishable with fine which may extend to ten thousand rupees.
- If any person holds any office in violation of disclosure provisions, it will result in vacation of office on and from the date next following the date of the general meeting of the company or as the case may be from the expiry of the period of three months.
- Such person is also liable to refund to the company any remuneration received or the monetary equivalent of any perquisite or advantage enjoyed by him or it for the period immediately preceding the date aforesaid.

Role of Audit Committee

3.11 Audit committee is expected to review, with the management, the annual financial statements before submission to the board for approval, with particular reference to disclosure of any related party transactions.³³ The term “related party transactions” in Clause 49 has the same meaning as contained in the AS 18. The Audit Committee it is required to mandatorily review amongst others, the information on “statement of significant related party transactions (as defined by the audit committee), submitted by management.” The duties of the audit committee include oversight of the financial reporting process of the company and related party transactions.³⁴

Disclosure by directors

3.12 Every director of a company, who is, directly or indirectly, concerned or interested in a contract or arrangement, or proposed contract or arrangement, entered into or to be entered into, by or on behalf of the company, must disclose the nature of his concern or interest at a meeting of the board of directors.³⁵ This provision to an extent overlaps the provisions of section 297 though being wider in scope and covers all kinds of contracts and arrangements and proposed contracts and arrangements including those mentioned in section 297. The term ‘arrangement’ can be widely interpreted. But this provision deals with contracts and arrangements of the company in which the directors are interested and not their relatives, partners, etc., unless ofcourse, the directors are themselves directly or indirectly interested or concerned in such contracts with the relatives, partners, etc. Disclosure by directors is not limited to only those transactions that are required to be approved by the board.³⁶

³³ Clause 49

³⁴ Corporate Governance in India: Theory and Practice, National Foundation for Corporate Governance (2004)

³⁵ Section 299 of the Companies Act, 1956

³⁶ *Rabindra Nath Mitra v Emperor*, (1938) 8 Com Cases 176 (Cal)

Manner and extent of disclosure by directors

3.13 **In the case of a proposed contract or arrangement, the disclosure required to be made by a director should be made at the meeting of the board at which the question of entering into the contract or arrangement is first taken into consideration.** If the director was not, at the date of that meeting, concerned or interested in the proposed contract or arrangement, it should be disclosed at the first meeting of the board held after he becomes so concerned or interested. In the case of any other contract or arrangement, the required disclosure has to be made at the first meeting of the board held after the director becomes concerned or interested in the contract or arrangement.

3.14 **It is considered sufficient disclosure and compliance if a general notice is given by the director to the board to the effect that he is a director or a member of a specified body corporate or of a specified firm.** This general notice would extend to and cover a notice and disclosure of interest in any contract or arrangement which may be entered with that body corporate or firm after the date of such general notice. The general notice is required to be provided in a statutory form provided under the Companies (Central Government's) General Rules & Forms, 1956.

3.15 **A general notice disclosing interest expires at the end of the financial year in which it is given.** It may however, be renewed for further periods of one financial year at a time, by a fresh notice given in the last month of the financial year in which it would otherwise expire. The notice given by an interested director has to be recorded in the minutes of the meeting of the board in which it is given or read.

3.16 **A director is required not merely to disclose that he is interested, but also the "nature of his concern or interest".** The director concerned must make full disclosure of his interest, including its extent and the amount of his profit or reward.³⁷ The intention of law is clearly to protect the company against a director who has a conflict of interest and duty. The requirement of law is of a full and frank declaration by the director, not of 'an' interest but the precise nature of the interest he holds, and, when his claims to the validity of a contract or arrangement depends upon it, he must show that he has in letter and spirit complied with the section and the company articles. The Indian courts have held that this principle was applicable with full force even in the case of one-director company.³⁸ The sole director has to remind himself of his duties of making a disclosure and recording it in accordance with the requirements of maintaining a company's records and minutes book and has to consider in good faith the interest of the company vis-à-vis his own interest giving preference to the company's interest. In this case an attempt was made to seek a summary judgment against a director by asking him to repay the money to the company which he had withdrawn as owing to him under the contract of employment. The court said that the summary judgment was not possible. The matter must be decided in a full trial on merits so as to see the director's bona fide in the matter and also whether disclosure requirements were complied with or not.

3.17 **A director must disclose to the Board interest of his relatives.** The Companies Act does not contemplate interest to be a personal interest only, nor is it confined to pecuniary interest only. If, to the knowledge of the director concerned, a relative of his coming within the list in Schedule 1 –A, is concerned in a contract or arrangement, the director must disclose the same to the Board. The expression, "in any way, whether directly or indirectly concerned or interested" if given its full meaning, would seem to include within its purview, also an interest in his relatives being concerned in any contracts or arrangements within the company.

³⁷ *Imperial Mercantile Credit Assn v Coleman*, (1983) LR 6 HL 189

³⁸ *Neptune (Vehicle Washing Equipment) Ltd. v. Fitzgerald* (1995) 1 BCLC 352 (Ch D),

Otherwise, an unscrupulous director may evade the provisions of the section by withholding information about contracts and arrangements brought about by or through his influence for the benefit of his relatives, without the board knowing the fact of their being his relatives and his being interested in their being benefited by the contracts or arrangement.

3.18 Interpretation and explanation given by MCA demonstrate that the policy makers seek strict interpretation of the disclosure provisions. Some of these clarifications are:

- The words ‘concern’ or ‘interest’ have not been defined in the Companies Act though it has been stated in subsection 3 (a) of the section 299 that where a director gives a general notice to the Board to the effect that he is a director or member of a specified body corporate or member of a specified firm and is to be regarded as concerned in any contract or arrangement which may be entered into with such body corporate or firm, such notice shall be deemed to have been sufficient disclosure of concern or interest in relation to any contract or arrangement so made. Where no such general notice has been given by the director or the other contracting party is not a body corporate or firm, the director will have to disclose the nature of his concern or interest as specified in section 299.
- So long as the director (the transferor) continues as the registered holder of shares in the register of members of the company he may be deemed prima facie to have an interest or concern in the arrangement or contract by virtue of such shareholding. Accordingly it will be advisable to disclose the facts relating to his shareholding in the company at the Board meeting in accordance with section 299(1) adding, if he considers necessary, that his shares having been transferred he is no longer personally interested in the company or the contract.
- Where a director is a trustee since the trustee is the owner of a share, it would be necessary in such cases to disclose to the company his ‘interest’ arising out of his membership in the companies concerned as a joint holder or a trustee as the case may be. (Company News and Notes, 1/7/1963 at pp. 81, 82)

Exception for disclosure

3.19 The requirements of disclosure by director do not apply to any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds or hold not more than two per cent of the paid-up share capital in the other company.

Consequences of non-disclosure

3.20 Failure by director to make the disclosure can be punishable with fine which may extend to fifty thousand rupees. Non-compliance by director does not however, avoid or invalidate the contract or arrangement but will make it voidable at the option of the company. It is also not unenforceable.³⁹ The Indian courts while interpreting the fate of such contracts rely on the principle laid by Lord Denning: nothing in this section shall be taken to prejudice the operation of any rule of law restricting a director of a company from having any concern or interest in any contracts or arrangements with the company.

3.21 A measure of the significance of RPTs is how many firms reported board review of RPTs. The 2006 survey shows that 33 of the respondent firms require RPTs to be on arms-

³⁹ *Naini Oxygen & Acetylene Gas Ltd. v Bisheshwar Nath*, (1986) 60 Com Cases 990 (All)

length firms. 60% of respondents reported that their board reviewed at least one RPT in the last year; 36% reported board review of five or more transactions.⁴⁰ 94% percent of firms that responded stated that they reported RPTs to shareholders, but this includes some firms which reported having no or negligible RPTs, and thus nothing to disclose (*Refer: Table 1*).

Interested Director to abstain from the proceedings of the Board

3.22 A director is prohibited to take part in the discussions and vote in the matter relating to a contract or arrangement in which he is interested.⁴¹ An interested director is not to be counted for constituting quorum at the time of such discussion and voting. If such a director votes in a matter in which he is interested, his vote shall be void. However, these prohibitions are not absolute in nature and are not applicable under certain exceptional circumstances. Even in such exceptional circumstances, it is important for an interested director to disclose his interest, but he is allowed to participate in the discussions and vote on those matters where he has personal interest. Following are the exceptional situations wherein the directors even though being personally interested, may participate and vote on those matters:

- (i) Contracts or arrangements executed by a private company, which is neither a subsidiary nor a holding company of a public company with any other company,
- (ii) Contracts or arrangements between a private company and its holding company, if the latter is a public company,
- (iii) If a director is surety for the company in a contract of indemnity that the company enters into, with any third party,
- (iv) Contract or arrangement with another public or private company, which is a subsidiary of a public company in which the director's interest solely consists of:
 - (a) being a director of the other company and holding only such number of shares (qualification shares)⁴², which shall entitle him to become a director of the other company, or
 - (b) holding not more than two percent of the paid up share capital of the other company.

3.23 Allowances may be made by the central government from the application of prohibitions relating to participation of interested directors in the proceedings of the board. Such allowances shall be made by way of a notification for a company or companies belonging to a particular industry, business or trade in order to promote that industry, business or trade. These special provisions may be for both, a public company or a private company that is a subsidiary of a public company.

Maintenance of register

3.24 The companies are required to maintain a register of RPTs at its registered office in the format and the procedure prescribed.⁴³ The register is open to inspection by all the members of the company during business hours subject to such reasonable restrictions as the company may impose so that not less than two hours in each day are allowed for such inspection. These registers are not available to the public. However, the RPTs are disclosed in

⁴⁰ N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008)

⁴¹ Section 300 of the Companies Act, 1956

⁴² Companies in India may impose a qualification on their directors to hold certain number of shares in order to become the director in that company

⁴³ Section 300 of the Companies Act, 1956

the annual report and the financial statements of the company, which are filed with the Registrar of Companies. These are available for inspection by the public. The register is required to be placed before the board and shall be signed by all the directors present at the meeting. In case of charitable companies, a register shall be maintained only of contracts to which sub-sections (1) and (3) of section 297 apply.

4.0 Shareholder Approval

Consent of shareholder

4.1 In India, only a few RPTs are required by the law to be approved by shareholders. Loans to directors and the facility of holding of office or place of profit by relative of a director are regulated through shareholder approval. The company is however, required to obtain a certificate from either the auditors or practising company secretaries regarding compliance of conditions of corporate governance which is sent annually to all the shareholders of the Company. The same certificate is also sent to the stock exchanges along with the annual report filed by the company.⁴⁴

4.2 Dr. J. J. Irani Committee has recommended that if the required quorum is not present at board meetings where the directors are interested it is desirable to place the proposed contract before the general meeting for consent of the shareholders. Mandatory shareholder approval of interested transactions protects against abuse and company asset stripping by insiders. To give transparency to RPTs, transactions beyond a specific limit be made subject to shareholders approval. The particulars/details pertaining to such contracts/arrangements to be included in the explanatory statement (to relevant special resolution), to be sent to shareholders, should be specified in the rules. Dr. J. J. Irani Committee noted that there is no difference between the RPTs that need board approval and those that that need shareholder approval.

5.0 Enforcement and Implementation

5.1 There are adequate provisions in law prescribing consequences, including penalties, for violation of RPTs related legal and regulatory provisions. Some of the relevant provisions are:

(i) Failure to make disclosure of interest or variation from the prescribed procedure of disclosure of interest by an interested director constitutes an offence and the director may be punished with a fine, which may extend to INR 50,000.

(ii) An interested director who votes in a matter in which he is interested is punishable with a fine, which may extend to INR 50,000.

(iii) Such a director would be liable to cease office⁴⁵ and failure to do so may subject him to prosecution⁴⁶

(iv) He would also have to refund his remuneration received after cessation of his directorship.

⁴⁴ Clause VII of clause 49 of Listing Agreements

⁴⁵ Section 283(1)(i) of the Companies Act, 1956

⁴⁶ Section 283(2A) of the Companies Act, 1956

(v) A non-disclosure required to be made under Section 299 does not invalidate the contract, but it becomes voidable at the option of the Board.

(vi) Non-compliance of provision for maintenance of RPTs register may lead to monetary sanctions, which may be levied on the company and on every officer in default, and the fine may extend to INR 5,000 for each default.

5.2 In cases of related party transactions where the consent of the Board is not obtained in due time in accordance with the stated procedure, the contract becomes voidable at the option of the Board, though the Board may at its discretion, condone the defect or delay for seeking consent and pass a resolution providing ex-post facto affirmation to the contract. Section 297 does not provide any penalty for non-compliance. The penalty, therefore, will be as per the provisions of section 621-A of the Act under which the directors concerned shall be punishable, with fine upto Rs. 5,000 and where the contravention is a continuing one, with a further fine upto Rs. 500 for every day of the default.

5.3 On paper, India has some of the best investor protection laws in the world. In reality, a slow judicial system, marked by overburdened courts, makes application of those laws far from a simple matter. Enforcement of corporate laws remains the soft underbelly of India's legal and corporate governance systems. While India observes or largely observes most of the principles, it could do better in many areas, including the use of nominee directors, the enforcement of laws and regulations pertaining to stock listing on major exchanges, insider trading, and dealing with violations of the Companies Act.⁴⁷ Some of these problems arise because of unsettled questions about jurisdictional issues and powers of the SEBI.

5.4 The Companies Act empowers the GoI to inspect the books of accounts of a company, to direct special audit, to order investigation into the affairs of a company and to launch prosecution for violation of the Companies Act. By virtue of section 408 of the Companies Act, the GoI is empowered to appoint such number of persons on the Board of the Company as directed by Company Law Board ('CLB') on the reference/application made by the Government to safeguard the interests of the company or its shareholders or the general public. The Central Government can also file petitions under section 402 read with section 406 of the Companies Act for disgorgement of assets against the Directors of the Company when they indulged in misappropriation/misfeasance.

5.5 The government enforcement remains weak. Although not much evidence is available of RPTs related actions taken by the GoI, an assessment of their enforcement actions can be gathered from the Annual Report of the MCA for the year 2006. During the period 1.4.2006 to 31.12.2006, the Government has filed petitions/applications before the CLB under sections 408 and 402 read with section 406 of the Act in respect of one company only. Petitions have been filed with the CLB under sections 397/398/402/408 read with section 406 of the Act in respect of two vanishing companies to disgorge the properties/money fraudulently obtained by promoters/Directors of these two vanishing companies. In one case i.e. M/s Nuline Glassware (India) Ltd., after obtaining concurrence of the Department of Legal Affairs, an Appeal has been filed before the Hon'ble High Court, Gujarat against the dismissal order passed by the CLB and the case is yet to be listed for hearing. In the other case i.e. M/s AVI Industries Ltd., arguments were heard and the judgement is reserved. Section 235 and 237 of the Companies Act empower the Central Government to order investigation into the affairs of a company under circumstances specified therein. The power to appoint inspectors to conduct investigation and to act on

⁴⁷ The World Bank's 2004 *Reports on the Observance of Standards and Codes (ROSC)*

report of investigation remains with the Central Government. The CLB is also empowered to consider application of members for conducting investigation into the affairs of a company. The powers to order investigation arise in circumstances where the business of a company is being conducted with intent to defraud its creditors, or for unlawful purposes, or in a manner oppressive to any of its members or that if the company was formed for any fraudulent or unlawful purposes. As per section 237(b) of the Companies Act, the Central Government may file petition before the CLB seeking order for investigation of the Company. As on 31.12.2006 one petition was pending before CLB. During the period from 1.4.2006 to 31.12.2006, 2 cases have been disposed of in High Courts while 6 cases are still pending under section 397/398 read with sections 406/408 & 237(b) of the Act. One Special Leave Petition was filed by Usha India vs GOI in the Supreme Court & the case is still pending before the Apex Court. During the period from 1.4.2006 to 31.12.2006, a total no. of 50874 prosecutions including 45705 prosecutions brought forward from the previous year were launched and pursued in the various courts under the Act. Out of these, 6984 prosecutions were disposed of and balances of 43890 prosecutions were pending as on 31.12.2006.

5.6 Case arrears and decade-long legal battles are commonplace in India. In spite of having around 10,000 courts (not counting tribunals and special courts), India has a serious shortfall of judicial servants. While the United States has 107 judges per million citizens, Canada over 75, Britain over 50 and Australia over 41, for India the figure is slightly over 10.⁴⁸ Amab Hazra and Maja Micevska report that about 20 million cases are pending in lower courts and another 3.2 million cases are pending in High Courts.⁴⁹ A termination dispute contested until all appeals are exhausted can take up to 20 years for disposal, while writ petitions in High Courts can take between 8 and 20 years. About 63% of pending civil cases are more than a year old, and 31% are over three years old. Automatic appeals, extensive litigation by the government, underdeveloped alternative mechanisms of dispute resolution like arbitration, and the shortfall of judges all contribute to this unenviable state of affairs in Indian courts. Since the same courts try both civil and criminal matters, and the latter gets priority, economic disputes suffer even greater delays.⁵⁰ Some High Court are highly efficient in disposal of cases.

5.7 In terms of the quality of public enforcement—or the nature and powers of the supervisory authority, SEBI earns a score 0.67, higher than the overall sample mean and the English-origin average of 0.52 and 0.62, respectively, and ranks 14th in the sample. This score was calculated using the framework of La Porta, et al (2006)—which focuses on disclosure and liability requirements as well as the quality of public enforcement of the regulations controlling securities markets.⁵¹ As for liability standards, India's score of 0.66 is the fifth highest, while the sample mean is 0.47. In terms of the quality of public enforcement—or the nature and powers of the supervisory authority—the Securities and Exchanges Board of India (SEBI) earns a score 0.67, higher than the overall sample mean and the English-origin average of 0.52 and 0.62, respectively, and ranks 14th in the sample. In comparing the regulatory powers and performance of the SEBI with those of America's Securities and Exchanges Commission, Suchismita Bose concludes that while the scope of Indian securities laws are quite pervasive, there are significant problems in enforcing compliance, particularly in areas like price manipulation and insider trading⁵². Between 1999 and 2004, SEBI took action in 481 cases as opposed to 2,789 cases for the SEC, even though

⁴⁸ Bibek Debroy, 1999, "Some issues in law reform in India",

⁴⁹ See Arnab K. Hazra and Maja Micevska, 2004. "The Problem Of Court Congestion: Evidence From Indian Lower Courts", *Working Paper*, University of Bonn.

⁵⁰ *Corporate Governance in India (2007)*, Rajesh Chakrabarti, William L. Megginson and Pradeep K. Yadav

⁵¹ This index is described in Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Sheifer, 2006. "What Works in Securities Laws?" *Journal of Finance* 61, pp. 1-32.

⁵² See Suchismita Bose, 2005. Securities Markets Regulation: Lessons from US and India Experience", *Money and Finance*, Jan-June, pp. 83-124

the latter regulates a significantly more mature market. As a ratio of actions taken to the number of companies under their respective jurisdictions, SEBI's figure comes out to be an unimpressive 0.09, while that of the SEC is 0.52. The ratio of action taken to investigations made is also quite low for the SEBI, with 1 out of 24 cases of issue related manipulation in 1996-97, and 7 out of 27 in the five-year period 1999-2004. As for appeals before higher authorities--the Securities Appellate Tribunal or the Finance Ministry--in 30 to 50% of cases, the decision goes against the SEBI. Though the SEBI has had some success prosecuting intermediaries, it has failed to convince the Securities Appellate Tribunal in its proceedings against corporate insiders and major market players. Thus the quality of public enforcement of securities laws in India appears problematic. SEBI is highly respected as a regulator. However, till 2007, SEBI had not initiated any significant penal proceedings for non-compliances of Clause 49. In matter of disclosures, India scores 0.92 in the index of disclosure requirements, which is the third highest after the United States and Singapore.

5.8 Government has a variety of powers to sanction directors and companies. These powers, however, are rarely exercised. These include the power to provide relief in cases of oppression and mismanagement, remove management, demand a special audit, inspect the company's accounts, and impose fines for certain Companies Act violations⁵³. The India Corporate Governance Survey 2006 shows the government has removed a director or blocked a director from serving at one Indian private firm and one foreign-controlled firm, dismissed an executive at one government firm, and ordered a special audit at three Indian private firms⁵⁴ (Refer: Table 4).

Table 4: Government Enforcement

Table shows number of responding firms with positive responses to the indicated questions about government enforcement. Sample is 301 Indian private firms and 69 government or foreign –controlled firms which responded to the India CG Survey 2006. Number of missing ranges from 1 to 2.

Enforcement action by Tribunal	Type of firm		
	Indian private	Government control	Foreign control
Removed director or blocked director from serving	1	0	1
Dismissed CEO	0	0	0
Dismissed another executive	0	1	0
Ordered special audit	3	0	0

Source: N. Balasubramaniam, Bernard S. Black, Vikramaditya Khanna, Firm-level Corporate Governance in Emerging Markets: A Case Study in India (Feb. 2008):

6.0 Fiduciary Duties of Boards and Shareholders' Redress

6.1 The Indian law and courts recognise the principle of fiduciary duty and responsibility of the board and individual directors. The burden lies on one who makes the allegation to prove his allegations. While directors have the authority to regulate the affairs of the company collectively as board, their duties of good faith and fair dealings are owed by each director individually. Directors have the duty not to place themselves in a position when

⁵³ Companies Act section 397-409(oppression remedy); section 388B(remove management); 233A(special audit);section 209 A(inspect books); section 168(fines)

⁵⁴ Due to the small number of positive responses, all three types of firms are included in Table 4 not only Indian private firms.

their fiduciary duties towards the company conflict with their personal interests. And in case it happens, directors have the duty to prefer interests of the company. Directors can not use company's assets, opportunities or information for their own profit.

6.2 Minority shareholders can file a complaint in the CLB when abusive RPTs inflict undue loss on a company. There are adequate provisions and remedies to prevent oppression and mismanagement. Any member of a company can complain that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members.⁵⁵ Minority, represented by specified number of members or members holding requisite percentage of equity capital is entitled to approach CLB for protection of their interests. CLB is empowered to order a number of remedial measures for regulation of the conduct of company's affairs. These measures, inter-alia, include purchase of shares or interest s of any members of company by other members; termination, setting aside or modification of agreements relating to managerial personnel; setting aside of transactions relating to transfer, delivery of goods, etc, or any other matter for which CLB feels that provisions should be made. CLB is also empowered to appoint such number of persons on the board as necessary to effectively safeguard interest of the company.

6.3 The powers of CLB to correct the wrong done in case of abusive RPTs are very wide. If the assets of a company were transferred to another company under the de facto control of same directors, with the result that it depresses the value of a member's shares in the company, CLB can pass an order not only against those who are in de facto control of the company at the material time, but also against the other company which is under the same de facto control and to which assets of the company have been transferred at an undervalue. In *Little Olympian Each-Ways Ltd. (No. 3), Re, (1995) 1 BCLC 636 (Ch D)* it was held that the group company to whom the assets were sold at under-value would be required to buy out the shares of aggrieved party at a price proportionate to the value at which the assets were resold to the third party buyer. In *Kuldip Singh Dhillon v. Paragaon Utility Financiers P. Ltd., (1988) 64 Com Cases 19 (P&H)* the court extended the scope of principle of oppression and mismanagement. It was held that where the company which owed shares in another company transferred these shares to its directors in a clandestine manner without receiving payment in cash and showed the amount in its books as a loan to the directors inspite of not being in a sound financial condition, the act of advancing the loan was held to be oppression of the minority.

6.4 The awareness of shareholders rights in particular by minority shareholders in case of abusive RPTs is very low. Very rarely do shareholders take the directors to courts on ground of abusive RPTs. During the period of nine months (1 April 2006 to 31 December 2006) only 530 complaints of oppression and mismanagement were received. It is not know how much of these pertain to RPTs.

7.0 Other measures to manage RPTs

7.1 A number of statutory provisions and guidelines deal with RPTs. Some of these are discussed below.

Transfer Pricing

7.2 The Indian Transfer Pricing regulations are broadly based on the transfer pricing guidelines issued by the Organization for Economic Co-operation and Development (OECD), but are unique in some respects. The Finance Act 2001 introduced

⁵⁵ Section 397 of the Companies Act,1956

detailed Transfer Pricing (TP) regulations w.e.f. 1st April, 2001, as a comprehensive anti-avoidance measure. The basic idea behind regulations is determining whether ‘international transactions’ between ‘associated parties’ are conducted at ‘arm’s length price’⁵⁶ The Indian TP regulations mandate that international transactions with related parties shall be determined having regard to the arm’s length price. In April 2002, the Central Government constituted an Expert Group to recommend transfer pricing guidelines for companies for pricing their products in connection with the transactions with related parties and transactions between different segments of the same company. The Expert Group recommended that Transfer Pricing Guidelines be framed and made as a part of the Act in the form of regulations. The Expert Group also produced draft guidelines which are attached as *Appendix D*.

7.3 The provisions of transfer pricing exist the Indian Customs Act, 1962 and the Indian Central Excise Act, 10944. A comparative chart of these provisions is attached as *Appendix E*. These provisions act as a disincentive to abusive RPTs.

7.4 The Income Tax Tribunal has held that a proper study of all the specific characteristics of the transaction needs to be undertaken, including analysis of functions, assets and risks. The comparison needs to take into account economically significant activities and responsibilities of the enterprises. A mere broad comparison is not enough. Tax payers need to undertake a detailed analysis while setting and documenting their transfer prices with related parties. This was held in a recent landmark transfer pricing ruling, pronounced on 2 November 2007 by the Income Tax Appellate Tribunal, reaffirmed the principle that transfer pricing is not an exact science in which mathematical certainty is possible and that some approximations cannot be ruled out. The tribunal ruled that it needs to be prima facie shown that the related party transaction was properly examined and that comparable prices were objectively fixed in a bona fide or honest manner, as required by law. Further, the ruling gives a direction to tax officers that once taxpayers undertake appropriate due diligence, their analysis cannot be rejected arbitrarily during audits based on inferences and presumptions.

Guidelines and best practices by Indian Chartered Accountants Institute (ICAI)

7.5 The ICAI provides for strict guidelines and best practices for their members which are at par with international standards. It is quite common for the chartered accountants of the public companies to provide for qualifications in the auditor report. In private companies, perhaps, the chartered accountants need to be more assertive while providing qualifications.

The Monopolistic and Restrictive Trade Practices Act (MRTP Act)

7.6 The Monopolistic and Restrictive Trade Practices Act (MRTP Act) deals with related parties from perspective of monopolistic and restrictive trade practices. The MRTP Act is under sun set as a new Competition Commission Act has been enacted recently. The MRTP Act defines “inter-connected undertaking” to mean two or more undertakings which are inter-connected with each other in any of the following manner, namely:

- If one owns or controls the other.
- Where the undertakings are owned by firms, if such firms have one or more common partners.
- Where the undertakings are owned by bodies corporate, -

⁵⁶ This is the price that would be charged in uncontrollable transactions, i.e. when parties are unrelated.

- if one body corporate manages the other body corporate, or
 - if one body corporate is a subsidiary of the other body corporate, or
 - if the bodies corporate are under the same management, or
 - if one body corporate exercises control over the other body corporate in any other manner;
- Where one undertaking is owned by a body corporate and the other is owned by a firm, if one or more partners of the firm hold, directly or indirectly, not less than fifty per cent of the shares, whether preference or equity, of the body corporate, or exercise control, directly or indirectly, whether as director or otherwise, over the body corporate,
 - If one is owned by a body corporate and the other is owned by a firm having bodies corporate as its partners, if such bodies corporate are under the same management,
 - If the undertakings are owned or controlled by the same person or by the same group,
 - If one is connected with the other either directly or through any number of undertakings which are inter-connected undertakings within the meaning of one or more of the foregoing sub-clauses.

7.7 A number of changes are expected in the RPTs management landscape in the approaching years. The policy makers and regulators have been discussing the possibilities of introducing further measures to contain the abuse of RPTs. In the year 2005, Dr. J.J. Irani Expert Committee on Company Law recommend the new company law framework. The Committee also reviewed the existing framework of RPTs to consider whether RPTs should be subject to a government-based regulatory regime or should be left to a self-regulatory mechanism based on shareholders approval and disclosure. The Committee concluded that while directors have the authority to regulate the affairs of the company collectively as Board, their duties of good faith and fair dealings are owed by each director individually. Directors have the duty not to place themselves in a position when their fiduciary duties towards the company conflict with their personal interests. And in case it happens, directors have the duty to prefer interests of the company. Directors should not use company's assets, opportunities or information for their own profit. The Committee deliberated on whether transactions/contracts in which directors or their relatives are interested should be regulated through a "Government Approval-based regime" or through a "Shareholder Approval and Disclosure-based regime". The Committee looked into international practices in this regard and felt that the latter approach would be appropriate in the future Indian context. A number of recommendations have been made by the Committee in this regard which have been discussed in the last section of this paper.

7.8 Dr. J.J. Irani Committee has recommended that certain transactions, in which directors are interested, should take place only subject to approval of board/shareholders. In addition to disclosure requirements in respect of all transactions/contracts/arrangements in which directors are interested, certain transactions, between company and director or persons connected with director, in respect of sale, purchase of goods, materials or services should take place only with the approval of Board of Directors. A threshold limit may be fixed under the Rules in respect of powers of the Board in this regard.

7.9 The Committee has further recommended that beyond a limit, the approval of shareholders, by special resolution, should be mandated. The particulars/details pertaining to such contracts/arrangements to be included in the explanatory statement (to relevant special

resolution), to be sent to shareholders, should be specified in the rules. Similar provisions should be applicable in respect of all transactions relating to transfer or lease of immovable property to/by the interested director by/to the company. The existing exemption under section 297 (2) (a) of the Companies Act in relation to transaction/contract/arrangement taking place for cash at market price should continue.

7.10 With respect to disclosures, the Committee has recommended that details of transactions of the company with its holding or subsidiary / fellow subsidiary or associate companies in the ordinary course of business and transacted on an arms length basis should be placed periodically before the board through the Audit Committee, if any. Details of transactions not in a normal course of business and / or not on an arms length basis with holding/subsidiary/fellow subsidiary/associate companies should be placed before the board together with management justification for the same. A summary of such transactions with each party should form part of the Annual Report of the company. Non compliance of these provisions should result into:-

- (a) Penalty on director who authorized transaction/contract etc. without approval of Board/General meeting.
- (b) Transaction/Contract being voidable at the option of the Board/Company.
- (c) Director concerned to account to the company for any gain made by him and to indemnify the company against wrongful gain made at the cost of the company.
- (d) The Director concerned being deemed to have vacated his office.
- (e) Disqualification of the director to hold office in the company for a prescribed period.

7.11 The Committee also made recommendations on restrictions on loan to director or holding office or place of profit by relative of director. Generally the directors should not be encouraged to avail of loans or guarantees from companies. They should be allowed remuneration or sitting fees only. In case company decides so, loans to directors should be allowed only when company by special resolution approves such loans. Disclosures to be made to shareholders, through the explanatory statement, should be specified in the rules. It should be open to a company to formulate schemes (such as Housing Loan Schemes) for the benefit of executive directors. Once such schemes are approved by the shareholders by special resolution, loans under such schemes may be allowed to eligible directors, without again going to shareholders for approval. It further recommended that transactions relating to short term Quasi-Loans to director or funding of director's expenditure (to be reimbursed by director later on) up to a specified limit (by rules) may be allowed subject to approval by the shareholders through special resolution.⁵⁷ Funding of Director's legitimate expenditure on duty to the company should be excluded from these regulations. Special provisions may be made for loans or quasi loans by money lending companies to its employee including directors to be allowed, subject to regulations of Reserve Bank of India and other regulators. The director or relatives of a director should be allowed to hold office or place of profit in the company upto a limit (to be specified by rules) only if shareholders, by special resolution, approve. (The office of managing director or whole time director should not be treated as office or place of profit.)

⁵⁷ Quasi loan is a transaction where one party - the creditor agrees to pay or pays otherwise than in pursuance of an agreement, a sum for another (the borrower) or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement expenditure incurred by a third party for the borrower on terms that the borrower would reimburse the creditor or in circumstances that give rise to a liability for the borrower to reimburse creditor.

7.12 The Committee also made recommendations on the duty on directors to disclose information relating to directorship and shareholdings in the company and in other companies. The Committee stated that every director should be under obligation to disclose to the company:-

- (i) Personal details as may be prescribed by way of rules.
- (ii) Directorships (including Managing Directorship, Whole Time-Directorship or Managership) held by him in any other company/firm.
- (iii) Shares or debentures held by him as well as his relative in the company and all other companies, as referred above.
- (iv) Names of companies in which director either singly or along with his relatives hold not less than a specified percentage of shareholding as may be specified by law.
- (v) Names of other entities in which he is directly or indirectly interested as partner, member or a key person, by whatever name called.
- (vi) Any changes in respect of above items [(i) to (v)] to the company should be informed within a time specified by law.

7.13 It was recommended that non disclosure of above information by any director should hold such director liable to pay fine. The company should keep a register containing relevant details mentioned above in respect of each director. Register should be open for inspection by all members of the company.

7.14 On director's duty to disclose interest, the Committee recommended that the Law should impose a duty on every director to disclose to the company, the contracts or arrangements with the company, whether existing or proposed or acquired subsequently, in which he, directly or indirectly, has any interest or concern. The manner, time limit and the extent of such disclosure should be specified in the Companies Act. The notice for relevant disclosure should be made by the interested director to the board of directors at a meeting of the board in which the transaction is to be discussed, so that information is available to the board in a timely manner. The provisions in the existing law to issue general notice by the directors in respect of their interest in contracts/arrangements by the company should continue. Failure to make disclosure should be treated as a default. director concerned should be held liable to penalties and he should be deemed to have vacated his office. This should also be a condition of disqualification to hold office of director of that company for a prescribed period. Directors' Responsibility Statement should include an additional clause to the effect that every director has made relevant disclosures as mentioned above. Interested director should abstain from participating in the Board meeting during consideration of relevant agenda item in which he is interested.

7.15 The company should maintain a register, in which all transactions above a prescribed threshold value in respect of contracts/arrangements, in which directors are interested, should be entered. The register should be kept at registered office of the company and should be open to inspection to all members.

7.16 **The recommendations of the Committee are expected to be implemented by introduction of relevant amendments in the new company law.** This is likely to address some concerns associated with RPTs in India. However, a study of RPTs related issues is required by policy makers will be useful in identifying the problems and challenges related with RPTs and considering appropriate solutions.

ANNEXURE IC

SUGGESTED LIST OF ITEMS TO BE INCLUDED IN THE REPORT ON CORPORATE GOVERNANCE IN THE ANNUAL REPORT OF COMPANIES

1. A brief statement on company's philosophy on code of governance.
2. *Board of Directors:*
 - i. Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
 - ii. Attendance of each director at the Board meetings and the last AGM.
 - iii. Number of other Boards or Board Committees in which he/she is a member or Chairperson.
 - iv. Number of Board meetings held, dates on which held.
3. *Audit Committee:*
 - i. **Brief description of terms of reference.**
 - ii. Composition, name of members and Chairperson.
 - iii. Meetings and attendance during the year.
4. *Remuneration Committee:*
 - i. **Brief description of terms of reference.**
 - ii. Composition, name of members and Chairperson.
 - iii. Attendance during the year.
 - iv. **Remuneration policy.**
 - v. Details of remuneration to all the directors, as per format in main report.
5. *Shareholders Committee:*
 - i. **Name of non-executive director heading the committee.**
 - ii. Name and designation of compliance officer.
 - iii. Number of shareholders' complaints received so far.
 - iv. **Number not solved to the satisfaction of shareholders.**
 - v. Number of pending complaints.
6. *General Body meetings:*
 - i. **Location and time, where last three AGMs held.**
 - ii. Whether any special resolutions passed in the previous 3 AGMs.
 - iii. **Whether any special resolution passed last year through postal ballot - details of voting pattern.**
 - iv. Person who conducted the postal ballot exercise.
 - v. Whether any special resolution is proposed to be conducted through postal ballot.
 - vi. **Procedure for postal ballot.**

7. Disclosures:

- i.* Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.
- ii.* Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.
- iii.* Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee.
- iv.* Details of compliance with mandatory requirements and adoption of the non-mandatory requirements of this clause.

8. Means of communication.

- i.* Quarterly results.
- ii.* Newspapers wherein results normally published.
- iii.* Any website, where displayed.**
- iv.* Whether it also displays official news releases; and.
- v.* The presentations made to institutional investors or to the analysts.**

9. General Shareholder information:

- i.* AGM : Date, time and venue.
- ii.* Financial year.
- iii.* Date of Book closure.
- iv.* Dividend Payment Date.
- v.* Listing on Stock Exchanges.
- vi.* Stock Code.
- vii.* Market Price Data: High, Low during each month in last financial year.
- viii.* Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
- ix.* Registrar and Transfer Agents.
- x.* Share Transfer System.
- xi.* Distribution of shareholding.
- xii.* Dematerialization of shares and liquidity.
- xiii.* Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity.
- xiv.* Plant Locations.
- xv.* Address for correspondence.

ANNEXURE ID

NON-MANDATORY REQUIREMENTS

(1) *The Board* - A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

(2) *Remuneration Committee*

- i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.
- ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.
- iii. All the members of the remuneration committee could be present at the meeting.
- iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

(3) *Shareholder Rights* - A half-yearly declaration of financial performance including summary of the significant events in last six months, may be sent to each household of shareholders.

(4) *Audit qualifications* - Company may move towards a regime of unqualified financial statements.

(5) *Training of Board Members* - A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

(6) *Mechanism for evaluating non-executive Board Members* - The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend/continue the terms of appointment of non-executive directors.

(7) *Whistle Blower Policy* - The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected

fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

ANNEXURE IB

**FORMAT OF QUARTERLY COMPLIANCE REPORT
ON CORPORATE GOVERNANCE**

Name of the Company:

Quarter ending on:

<i>Particulars</i>	<i>Clause of Compliance Listing agreement</i>	<i>Status Yes/No</i>	<i>Remarks</i>
	49 (I)		
I. Board of Directors			
(A) Composition of Board	49 (IA)		
(B) Non-executive Directors' compensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct	49 (ID)		
	49 (II)		
II. Audit Committee			
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 (IIB)		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 (IID)		
(E) Review of Information by Audit Committee	49 (IIE)		
	49 (III)		
III. Subsidiary Companies			
	49 (IV)		
IV. Disclosures			
(A) Basis of related party transactions	49 (IVA)		
(B) Board Disclosures	49 (IVB)		
(C) Proceeds from public issues, rights issues, preferential issues etc.	49 (IVC)		
(D) Remuneration of Directors	49 (IVD)		
(E) Management	49 (IVE)		
(F) Shareholders	49 (IVF)		
	49 (V)		
V. CEO/CFO Certification			
VI. Report on Corporate Governance	49 (VI)		

VII. Compliance

Notes:

(1) The details under each head shall be provided to incorporate all the information required as per the provisions of the clause 49 of the Listing Agreement.

(2) In the column No. 3, compliance or non-compliance may be indicated by Yes/No/N.A. For example, if the Board has been composed in accordance with the clause 49-I of the Listing Agreement, “Yes” may be indicated. Similarly, in case the company has no related party transactions, the words “N.A.” may be indicated against 49 (IVA).

(3) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the “Remarks” column as - “will be complied with at the AGM”. Similarly, in respect of matters which can be complied with only where the situation arises, for example, “Report on Corporate Governance” is to be a part of Annual Report only, the words “will be complied in the next Annual Report” may be indicated.

DRAFT TRANSFER PRICING GUIDELINES

In exercise of the powers conferred by sub-section (1) of section 642, read with clause (e) of sub-section (1) of section 209 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following guidelines, namely :-

1. Short title and Commencement.-

- (1) These guidelines may be called “Transfer Pricing Guidelines, 2002”.
- (2) These guidelines shall come into force on the date of their publication in the official gazette.

2. Application.-

These guidelines shall apply to such transactions, which a company may enter into with its related party or within its segments per se.

Provided that nothing contained herein shall apply to those transactions where the transaction price is fixed by any Government department or authority pursuant to any Law or Act of Parliament.

3. Definitions.-

In these guidelines, unless the context otherwise requires -

- (1) **“arm’s length price”** means the price, which is applied in a transaction between persons other than related party in uncontrolled conditions.
- (2) **“related party”**, in relation to a company, means an entity -
 - (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa; or
 - (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa.

An entity shall be deemed to be a related party in relation to a company if, at any time during the previous year -

- (a) the entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in such company or vice versa; or
- (b) any person or entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in each of the entities; or
- (c) a loan advanced by the entity to the company constitutes not less than fifty-one percent of the book value of the total assets of the company or vice versa; or
- (d) the entity guarantees not less than fifty-one percent of the total borrowings of the company or vice versa; or

- (e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of the entity, are appointed by the company or vice versa ; or
 - (f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the entity and the company are appointed by the same person or persons; or
 - (g) the manufacture or processing of goods or articles or business carried out by the entity is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the company is the owner or in respect of which the company has exclusive rights or vice versa; or
 - (h) ninety percent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the entity, are supplied by the company, or by persons specified by the company, and the prices and other conditions relating to the supply are influenced by such company or vice versa; or
 - (i) the goods or articles manufactured or processed by the entity, are sold/transferred to the company or to persons specified by the company, and the prices and other conditions relating thereto are influenced by such company or vice versa; or
 - (j) where the entity is controlled by an individual, the other company is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
 - (k) where an entity has the power to direct, by statute or agreement, the financial and operating policies of the company or vice versa;
 - (l) there exists between two entities, any relationship of mutual interest as may be prescribed provided one of them is a company.
- (3) **“entity”**.- the term “entity” means an individual or a Hindu undivided family or a partnership firm or an association of persons or a trust or a company.
- (4) **“relative”**.- A person shall be deemed to be a relative of another; if, and only if,-
- (a) they are members of a Hindu undivided family; or
 - (b) they are husband and wife; or
 - (c) the one is related to the other in the manner indicated in Schedule I A of the Companies Act, 1956.
- (5) **“segment”** means any business segment for which financial results are prepared either for the purpose of segmental reporting or for complying with or availing benefits under the provisions of any of the Acts or Laws.
- (6) **“transaction”** includes any sale, purchase, transfer, arrangement, understanding or action, whether formal or informal, whether oral or in writing, whether legally enforceable or not with respect to :
- (a) raw materials, process materials, utilities like water, steam, gas, air, power, effluent treatment facility, finished products and rejected goods including scraps, etc;
 - (b) utilisation of plant facilities and technical know-how;

- (c) rendering or receiving of services including deputation of man power;
- (d) administrative, technical, managerial or any other consultancy services;
- (e) capital goods including plant and machinery;
- (f) lease of tangible or intangible property;
- (g) provision of finance (including loans, advances and equity or other contribution in cash or in kind);
- (h) agency and distribution arrangements;
- (i) leasing or hire purchase arrangements;
- (j) transfer of or sharing of the benefits of research and development;
- (k) licence or know-how agreements;
- (l) guarantees and collaterals;
- (m) management contracts;
- (n) any work in pursuance to a contract;
- (o) any other sharing or provision of resources or undertaking of obligations between or on behalf of related parties regardless of whether or not a price is charged.

4. Transactions to be at arm's length price

All transactions between a company and a related party or between two business segments of a company shall be at arm's length transfer prices determined in accordance with Clause 5.

Provided that in exceptional cases, the company may decide to use a non-arm's length transfer price if the Board of Directors as well as the audit committee of the Board are satisfied for reasons to be recorded in writing that it is in the interest of the company to do so. In all such cases, the use of a non-arms length transfer price, the reasons therefor, and the profit impact thereof shall be disclosed in the annual report.

5. Methods of Computation Of Arm's Length Price

The arm's length price shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction, namely :-

- (1) Comparable Uncontrolled Price Method
- (2) Resale Price Method
- (3) Cost Plus Method
- (4) Profit Split Method
- (5) Transactional Net Margin Method
- (6) Any other basis approved by the Central Government, which has the effect of valuing such transaction at arm's length price.

(1) Comparable Uncontrolled Price (CUP) Method :

The price charged or paid in a comparable uncontrolled transaction or a number of such transactions shall be identified. Such price shall be adjusted to account for differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price shall be taken as arm's length price.

The uncontrolled transaction means a transaction between independent enterprises other than related parties and shall cover goods or services of a similar type, quality and quantity as those between the related parties and relate to transactions taking place at a similar time and stage in the production/distribution chain with similar terms and conditions applying.

(2) Resale Price Method :

The price at which the goods purchased or services obtained from a related party is resold or is provided to an unrelated entity shall be identified. Such resale price shall be reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar goods or services in a comparable uncontrolled transaction or a number of such transactions. The price so arrived at shall be further reduced by the expenses incurred by the enterprise in connection with the purchase of goods or services. Such price shall be further adjusted to take into account the functional and other differences including differences in accounting practices, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. The adjusted price shall be taken as arm's length price in respect of goods purchased or services obtained from the related party.

The resale price method would normally be adopted where the seller adds relatively little or no value to the product or where there is little or no value addition by the reseller prior to the resale of the finished products or other goods acquired from related parties. This method is often used when goods are transferred between related parties before sale to an independent party.

(3) Cost Plus Method :

The total cost of production incurred by the enterprise in respect of goods transferred or services provided to a related party shall be determined. The amount of a normal gross profit mark-up to such costs arising from the transfer of same or similar goods or services by the enterprise or by an unrelated enterprise in a comparable uncontrolled transaction or a number of such transactions, shall be determined. The amount of a normal gross profit mark-up shall be adjusted to take into account the functional and other differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market. The total cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. It is also important here to ensure that the cost base to which mark-up is applied is comparable to the cost base of the third party transaction which serve as comparable. For example, it may be necessary to make an adjustment to cost where one person leases its business assets while other owns its business assets.

The cost plus method would normally be adopted if CUP method or resale price method cannot be applied to a specific transaction or where goods are sold between associates at such stage where uncontrolled price is not available or where there are long term buy and supply arrangements or in the case of provision of services or contract manufacturing.

(4) Profit Split Method :

The combined net profit of the related parties arising from a transaction in which they are engaged shall be determined. This combined net profit shall be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of transaction in which it is engaged with reference to market returns achieved for similar types transactions by independent enterprises. The residual net profit, thereafter, shall be split amongst the related parties in proportion to their relative contribution to the combined net profit. This relative contribution of the related parties shall be evaluated on the basis of the function performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined net profit will then be split amongst the enterprises in proportion to their relative contributions. The profit so apportioned shall be taken into account to arrive at an arm's length price

This method would normally be adopted in those transactions where integrated services are provided by more than one enterprise or in the case multiple inter-related transactions which cannot be separately evaluated.

(5) Transactional Net Margin Method :

The net profit margin realised by the enterprise from a related party transaction shall be computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions, shall also be computed having regard to the same base. This net profit margin shall be adjusted to take into account the differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such net profit margin in the open market. The cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. The adjusted net profit margin shall be taken as arm's length price.

This method would normally be adopted in the case of transfer of semi finished goods.; distribution of finished products where resale price method cannot be adequately applied; and transaction involving provision of services.

6. Authentication of the documents provided by the company

The information/documents provided by the company to the auditor for certification as provided in clause 7 hereof shall be signed on behalf of the Board by the Company Secretary and at least one Director of the company. In the absence of Company Secretary in the company, the same shall be signed by at least two Directors of the company on behalf of the Board.

7. Certification of Related Party Transactions

A report on the compliance of the transfer pricing guidelines **in respect of transactions with related parties** shall be obtained from an independent Chartered Accountant in whole-time practice or Cost Accountant in whole-time practice in the format prescribed hereunder. Such audit report shall be published in the annual report of the company in the event of any qualification or disagreement with the Board of Directors on any transaction.

- (i) I/We* have audited the accompanying Schedule A – Record of transactions entered into by the company with related parties. This schedule is the responsibility of the Company’s management. My/Our* responsibility is to express an opinion on this schedule based on our audit.
- (ii) The Report on Implementation of Transfer Pricing prepared under clause 10 has been furnished by the company and has been examined and verified by me/us*.
- (iii) I/We* conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that I/we* plan and perform the audit to obtain reasonable assurance about whether the record of transactions entered into with related parties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of accounts receivable. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. I/We* believe that my/our* audit provides a reasonable basis for our opinion.
- (iv) In my/our* opinion, the record of transactions entered into with related parties referred to above presents fairly, in all material respects, the related party transactions of the company in conformity with accounting principles generally accepted in India.
- (v) The financial information given in the above statement is in agreement with the records and documents furnished to me/us*, and the same has been incorporated in the books of accounts maintained by the company.
- (vi) I/We* are not a related party of the company as defined in the Transfer Pricing Guidelines

Signature and Stamp/Seal of the
Chartered Accountant /Cost Accountant
Name of the Signatory, Membership No. and Full Address

Place :

Date :

*Delete whichever is not applicable.

9. Directors’ Certificate on Transfer Pricing Guidelines

The Directors’ Report shall contain a certificate in the following format:

To the Members

It is certified that the company has complied with the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956. The information pursuant to these Guidelines is given in Annexure ‘A’ to this Certificate. We believe that the record of transactions entered into with related parties during the period from _____ through _____ are at arm’s length and not prejudicial to the interests of the company. These transactions are entered into on the basis of a transfer pricing policy adopted by the company. All transactions have been submitted to the independent auditors for audit. [No adverse remarks have been made in their report on the audit of such transactions]/[The auditors have qualified their report and the audit report is attached] *.

Date:

For and on behalf of
Board of Directors

Place :

*Delete whichever is not applicable.

9. Disclosures in the Directors’ Report

The Directors' Report shall contain the following disclosures relating to transfer pricing:

The record of transactions entered into with related parties in the format specified in Schedule A.

Transfer Pricing Policy Statement describing the strategies and policies influencing the determination of transfer price in a format as close to Schedule B as may be practicable.

Management perception of risk factors involved, if any.

The amounts or appropriate proportions of outstanding items pertaining to related parties balances and provisions for doubtful debts due from such parties as on Balance sheet date.

Any other material information pertaining to related party transactions that are necessary for understanding of the financial statements or are required to be disclosed under any other law or under any accounting standard. The disclosures required under these guidelines as well as the disclosures regarding related party transactions required under other laws or under accounting standards would appear together in the Annual Report in order to be more meaningful and to enhance ease of understanding.

10. Transfer Price Implementation Report

The company shall prepare a Report on Implementation of Transfer Pricing documenting the compliance with the Guidelines and the Transfer Price Policy Statement. This report shall be placed before the Audit Committee of the Board of Directors for approval. It shall also be submitted to the independent auditor appointed under clause 7. This report shall include the following information:

List of related parties with whom the Company has entered into transactions with the following details :

- (i) General information of related party such as name, trade name, address etc.
- (ii) Nature of relationship with the related party.
- (iii) Brief description of the business carried on by the related party.
- (iv) If the related party is a foreign party, the name, trade name and address of their permanent establishments located abroad.

Nature and Description of the transaction carried/undertaken by related party, specifying the category of transactions in terms of the list given in clause 3(6).

(This has to be given along with volume of the transaction. In case this is not possible, then, approximate value of the transaction should be given).

Terms and conditions of the transaction undertaken by the company with the related parties and the quantity purchased/sold.

Method adopted for determining transfer price. In case there is an established price for an unrelated party, then, how much is the difference, by adopting different method, for related party.

Detailed assumptions and estimates underlying the transfer price and the details of the computation of the transfer price.

The following additional information in respect of lending or borrowing:

- (i) Nature of financing agreement.
- (ii) Currency in which loan/advance granted/received.
- (iii) Interest rate charged/paid in respect of each loan/advance.

If the company has entered into any transaction with a related party by way of a mutual agreement or arrangement for the allocation of or apportionment of, or any contribution to, any cost or expense incurred or to

be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such entrepreneurs, description of such mutual agreement or arrangement.

Any other material information pertaining to related party transactions necessary for understanding of the financial statements.

Schedule A – Record of transactions entered into with related parties

Name of related party	Nature of transaction	Amount (Rs.)	Transacted at arm’s length basis (Yes/No)	Remarks* (in case of exceptions to arm’s length basis of trading)

* If the company has not followed the method prescribed under the guidelines in pricing of the transaction with any related party, the impact thereof on the profits/losses of the company shall be indicated here.

Schedule B: Illustrative Statement on Transfer Pricing Policy

Objective

- The primary objective of this Statement on Transfer Pricing Policy (the “Statement”) is to ensure that all transactions between the company and related parties or between two business segments of the company are ordinarily at arm’s length transfer prices. The Board of Directors (“BOD”) believes that this process enhances the transparency, integrity and quality of financial reporting and would comply with regulatory requirements in this regard.

Scope

- This Statement applies to all transactions where a related party relationship exists between the company and that other transacting party as also transactions between two business segments of the company.
- This Statement will not be applied in respect of transactions between the company and its consolidated subsidiaries, in respect of consolidated financial statements, since such transactions will be eliminated during the consolidation process. Provided that if the subsidiary or subsidiaries constitute a business segment, this Statement will apply to that subsidiary or those subsidiaries as it does to other business segments.

Definitions

- For the purposes of this Statement, the terms “*transactions*”, “*arm’s length*”, “*related party*” and “*business segment*” have the meanings assigned to them under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956.

Statement of Policy

5. All transactions between the company and its related parties or between any two or more business segments of the company shall normally be contracted on an arm's length basis as required under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956.
6. For each related party, a statement shall be recorded disclosing the basis/methodology for various transactions and shall form the basis on which transactions are entered into.
7. In respect of each such transaction with each related party, a record shall be maintained giving the following particulars:
 - Name of the contracting party;
 - Nature of the transaction;
 - Terms and conditions of the transaction undertaken including the amount of consideration received or given up;
 - Basis or methodology of determining such consideration;
 - Detailed assumptions and estimates underlying the transfer price and the details of the computation of the transfer price.

A statement whether, in management's opinion, such consideration is at an arm's length basis with specific reference to a comparable uncontrolled price or a comparable uncontrolled transaction. Such statement can be prepared and presented annually; and

This record may also be maintained for a group of similar transactions
8. The policy on entering into a transaction with a related party shall be placed before the BOD/independent audit committee of the BOD for approval before any such transactions are entered into.
9. The records of all such transactions with each such related party shall be placed before the Board of Directors at each Board meeting for formal approval/ratification.
10. Where an officer of the company (as defined under the Companies Act, 1956) possesses knowledge that a transaction may not be consummated on an arm's length basis due to certain specific circumstances, he/she shall inform the BOD within ____ business days, also giving reasons for deviation from an arm's length basis of pricing.
11. The BOD has discretionary authority to formally approve such exceptional transactions. It should also place such transactions together with reasons for deviations from the policy before the independent audit committee for their ratification.
12. The records of all such related party transactions (including exceptional transactions) shall also be placed before the independent audit committee of the company at each meeting of the audit committee for their approval.
13. It should be appreciated that the record of related party transactions contains commercially confidential information that is not appropriate for wider disclosure.
14. At the end of every financial reporting period (quarterly, half-yearly or annual), an Implementation Report shall be prepared and presented before the Board of Directors for their approval. (This can form part of the Directors Responsibility Statement, signed by the Managing Director and Chairman and placed before the BOD together with the audit report referred to in paragraph 17 below)

15. The record of related party transactions shall be audited on a (quarterly/half yearly/annual) basis by an independent auditor as required under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956. The audit report shall be taken on record at the meeting of the Board of Directors. ***Such audit report shall be published in the annual report of the company in the event of any qualification or disagreement with the BOD on any transaction.***
16. Any amendments to this Statement shall be effective only if taken on record and approved by the independent audit committee and the Board of Directors of the company.
17. This Statement was taken on record and approved by the independent audit committee at their meeting held on _____, 20XX.
18. This Statement was taken on record and approved by the Board of Directors at their meeting held on _____, 20XX.

Comparative Chart Showing Provisions Relating to Transfer Pricing under Different Laws and Regulations

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
I Type of Transactions			
<p>This Act relates to International Transactions.</p> <p>These transactions have been defined under Section 92B of the Act.</p>	<p>This Act relates to transactions relating to exportation and importation in the course of International Trade.</p> <p>(However, the term International Trade has not been defined under the Act)</p>	<p>This Act relates to transactions relating to Captive consumption of goods and related party transactions.</p>	<p>This Standard covers related party transactions. These transactions involve transfer of resources or obligations between related parties, regardless of whether or not a price is charged. This Standard became effective in respect of accounting periods commencing on or after 1.4.2001.</p> <p>AS-18 is mandatory only in respect of following enterprises and not all enterprises as at present :</p> <p>(i) Enterprises whose equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the Board of directors' resolution in this regard.</p> <p>All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 crores.</p>
II. Associated enterprise/Associated persons/ Related party/Related person (see below for Companies Act and MRTP Act definitions)			
<p>The term "Associated enterprise has been defined under Section</p>	<p>This Act provides for the definition of the</p>	<p>The Act provides for the definition of the term related person under Section</p>	<p>Accounting Standard-18 provides for the definition of the term 'related party' as per which parties are considered to be related if</p>

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>92A of the Act. As per this Section-</p> <p>(1)"associated enterprise", in relation to another enterprise, means an enterprise -</p> <p>(a)which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or</p> <p>(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.</p> <p>(2) Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, -</p> <p>(a) one enterprise holds, directly or</p>	<p>term Related person under Rule 2 (2) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988. As per this rule—</p> <p>Persons shall be deemed to be "related" only if -</p> <p>(i) they are officers or directors of one another's businesses;</p> <p>(ii) they are legally recognised partners in business;</p> <p>(iii) they are employer and employee;</p> <p>(iv)any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares or both of them;</p> <p>(v)one of them directly or indirectly controls</p>	<p>4 (3)(b) which provides-</p> <p>Persons shall be deemed to be "related" if-</p> <p>(i) they are inter-connected undertakings;</p> <p>(ii) they are relatives;</p> <p>(iii) amongst them the buyer is a relative and a distributor of the assessee, or a sub-distributor of such distributor; or</p> <p>(iv) they are so associated that they have interest, directly or indirectly, in the business of each other;</p> <p>Explanation to the clause provides "inter-connected undertakings" shall have the same meaning as provided in section 2(g) of the MRTP Act, 1969 and the term "relative" shall have the same meaning as provided in Section 2(41) of the Companies Act, 1956.</p>	<p>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.</p> <p>The term control means :</p> <p>(a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or</p> <p>(b) control of the composition of the Board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or</p> <p>(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.</p> <p>An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.</p> <p>The term significant influence refers to participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. Significant influence may be exercised in</p>

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or</p> <p>(b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or</p> <p>(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or</p> <p>(d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or</p> <p>(e) more than half of the Board of directors or members of the governing board, or one or more executive directors or executive members of the governing Board of one enterprise, are appointed by the other enterprise; or</p> <p>(f) more than half of the directors</p>	<p>the other;</p> <p>(vi) both of them are directly or indirectly controlled by a third person;</p> <p>(vii) together they directly or indirectly control a third person; or</p> <p>(viii) they are members of the same family.</p> <p>Explanation I to the Rule provides that the term "person" also includes legal persons.</p> <p>Further it has been provided in Explanation II that Persons who are associated in the business of one another in that one is the sole agent or sole distributor or sole concessionaire, however described, of the other shall be deemed to be related for the purpose of these rules, if they fall within</p>		<p>several ways, for example</p> <ul style="list-style-type: none"> - by representation on the Board of directors, - participation in the policy making process, - material inter-company transactions, - interchange of managerial personnel, or - dependence on technical information. <p>For the purposes of this standard an associate is an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.</p> <p>A joint venture is a contractual agreement whereby two or more parties undertake an economic activity which is subject to joint control. The term joint control refers to the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.</p> <p>This standard provides for the definition of the term relative as per which 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.</p>

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>or members of the governing Board, or one or more of the executive directors or members of the governing Board, of each of the two enterprises are appointed by the same person or persons; or</p> <p>(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or</p> <p>(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles</p>	<p>the criteria of this sub-rule.</p>		

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or</p> <p>(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or</p> <p>(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or</p> <p>(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu</p>			

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>undivided family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative; or</p> <p>(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or</p> <p>(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.</p>			
III. Basis of Determination of Price			
<p>Computation of Income from International Transactions shall be done having regard to arm's length price as per section 92C where under six methods are prescribed namely :</p> <p>(a) comparable uncontrolled price method;</p>	<p>Section 14 of the Act provides for valuation of goods. Valuation of the such goods shall be deemed to be the price at which such goods or like goods are ordinarily sold or offered for sale for delivery at the time and</p>	<p>Section 4 of the Act provides for valuation of excisable goods for purposes of charging of duty of excise where under, the duty of excise is chargeable on any excisable goods with reference to their value. On each removal of the goods, such value shall in a case where the goods are sold by the assessee for delivery at the time and place of removal, the</p>	<p>It requires disclosure of information regarding related parties and transactions with related parties that are recognized in the financial statements of an enterprise.</p> <p>This standard establishes the requirements for disclosure of :</p>

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
<p>(b) resale price method;</p> <p>(b) cost plus method;</p> <p>(c) profit split method;</p> <p>(d) transactional net margin method;</p> <p>(e) such other method as may be prescribed by the Board.</p> <p>“Arm’s length price” means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.</p>	<p>place of importation or exportation, as the case may be, in the course of international trade where the seller and buyer have no interest in the business of each other and the price is the sole consideration for sale or offer for sale.</p> <p>Rule 4(3) of Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 provides that where the seller and buyer are related to each other, the value shall be accepted provided that the examination of the circumstances of the sale of the imported goods indicate that the relationship did not influence the price.</p> <p>However, Where the</p>	<p>assessee and the buyer of the goods are not related and the price is the sole consideration for the sale will be the transaction value.</p> <p>In any other case, including the case where the goods are not sold, the value shall be determined in such manner as may be prescribed. However, this section is not applicable in respect of any excisable goods for which a tariff value has been fixed under Section 3(2) of the Act. Where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles or where the assessee so arranges that the excisable goods are not sold by him except to or through a related person in such a situation the value shall be determined as per Rules 8, 9 and 10 of the Central Excise (Determination of Price of Excisable Goods) Rules, 2000. These Rules provide that—</p> <p>Where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf</p>	<p>- related party relationships; and</p> <p>- transactions between a reporting enterprise and its related parties.</p> <p>Disclosures under this standard is a means of conveying to the users that certain related party relationship exists or related party transactions have taken place and that the results of these transactions have been incorporated in the financial statements. These disclosures will make financial statements more transparent and users of financial statements can make informed decisions based on it.</p>

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
	<p>buyer and seller are related, the transaction value shall be accepted provided that the examination of the circumstances of the sale of the imported goods indicate that the relationship did not influence the price.</p> <p>In a sale between related persons, the transaction value shall be accepted, when-ever the importer demonstrates that the declared value of the goods being valued, closely approximates to one of the following values ascertained at or about the same time -</p> <p>(i) the transaction value of identical goods, or of similar goods, in sales to unrelated buyers in India;</p> <p>(ii) the deductive value for identical goods</p>	<p>in the production or manufacture of other articles, the value shall be one hundred and fifteen per cent of the cost of production or manufacture of such goods. (Rule 8)</p> <p>When the assessee so arranges that the excisable goods are not sold by an assessee except to or through a person who is related in the manner specified in either of sub-clauses (ii), (iii) or (iv) of clause (b) of sub-section (3) of section 4 of the Act, the value of the goods shall be the normal transaction value at which these are sold by the related person at the time of removal, to buyers (not being related person); or where such goods are not sold to such buyers, to buyers (being related person), who sells such goods in retail :</p> <p>It is however provided that in a case where the related person does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value shall be determined in the manner specified in Rule 8. (Rule 9)</p> <p>When the assessee so arranges that the excisable goods are not sold by</p>	

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
	<p>or similar goods;</p> <p>(iii)the computed value for identical goods or similar goods.</p> <p>Provided that in applying the values used for comparison, due account shall be taken of demonstrated difference in commercial levels, quantity levels, adjustments in accordance with the provisions of Rule 9 of these rules and cost incurred by the seller in sales in which he and the buyer are not related;</p> <p>Substituted values shall not be established under the above provisions.</p>	<p>him except to or through an inter-connected undertaking, the value of goods shall be determined in the following manner, namely :-</p> <p>(a) If the under-takings are so connected that they are also related in terms of sub-clause (ii) or (iii) or (iv) of clause (b) of sub-section (3) of Section 4 of the Act or the buyer is a holding company or subsidiary company of the assessee, then the value shall be determined in the manner prescribed in rule 9.</p> <p>(b)In any other case, the value shall be determined as if they are not related persons for that purposes of Section 4(1). (Rule 10) .</p>	