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(AN M. DAMODARAN INITIATIVE)

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MINIMUM INFORMATION – MAXIMUM PRESCRIPTION

When constituting Boards and committees, it is reasonable to presume that the persons being inducted are persons of reasonably high intellect, with a commitment to safeguarding, and promoting, the interests of the company, and its stakeholders. Is it then necessary to spoon feed such persons by listing every conceivable action that they should take as members of Boards and committees?

Speaking at a function to launch the industry standards on minimum information to be provided to Audit Committees (ACs) for approval of Related Party Transactions (RPTs), the SEBI Chairperson is reported to have said that she would have no problem throwing the entire SEBI LODR Regulations, 2015 (LODR) into the bin if provisions for RPTs were retained. The minimum information that the 3 apex chambers have finalised as the industry standards, leaves one wondering whether the extremely detailed information to be provided to the AC will lead to RPTs also being thrown into the bin, in due course.

Along with Regulations relating to Prohibition of Insider Trading, RPTs constitute the area in which changes and refinements have been introduced at frequent intervals. It is almost as if the phenomenon of RPTs is giving sleepless nights to those tasked with regulations. Getting the apex industry fora to be partners in this endeavour will perhaps ensure that neither they, nor their constituents, can complain about the extraordinary level of detail that is sought to be provided to the AC.

RPTs have been provided for in the Companies Act, 2013 (the Act). All that they provide for is that the transactions should be in the ordinary course of business and at arm's length. It has been left to the ACs of the various corporates to figure out the tests that they will put in place to ensure that these twin requirements are appropriately met. In some cases, the corporates, especially the ACs thereof, have reached out to external agencies to determine whether both these requirements have been suitably addressed.

Over the years, especially in the recent past, RPTs have acquired a negative connotation. One is reminded of a conversation several decades ago with the then-Director CBI, a good man, who is no longer in our midst, who claimed that all non-performing assets (NPAs) were frauds, and was unwilling to concede that there could be other reasons for an asset turning into an NPA. RPTs, viewed through a similar suspicious lens, also seem to qualify as necessarily avoidable and irregular. The fact that RPTs have been specifically provided for in the Act and in LODR should lend some legitimacy to the conclusion that they do belong in the sphere of business activities.

It is useful to revisit the basics. The first requirement is that a transaction should be in the ordinary course of business. For example, it is not open to entities of a large conglomerate to place orders for several thousand vehicles, which are not needed, only to bail out an automobile company, which belongs to that group. By all accounts, this is clearly not a transaction in the ordinary course of business.

The other requirement is that the transaction should be at arm's length. While arm's length has not been defined in the Act, recourse can be had to taxation provisions. Simply stated, arm's length

pricing would involve ensuring that the Related Party (RP) does not get a price that is advantageous, as compared to the price at which goods and services are provided to, or received from, an unrelated party.

It is now time to turn to minimum information as set out in the industry standards. Over 32 pages, with tabular statements, replete with micro details, the minimum information to be provided for review by the AC and the shareholders for approval of RPTs has been stipulated. Some of the provisions therein merit special comment. To begin with, there is an applicability matrix which sets out the threshold, the approvals required, and the disclosure requirement. There are 6 explanations attached to this applicability matrix. Moving on, the standards for minimum information provide *inter alia* that while collecting and collating the information, the management of the listed entity shall take into account certificates from the CEO or CFO or any other Key Managerial Personnel (KMP) of the listed entity, and from every Director of the listed entity, who is a promoter (promoter Director), that the RPTs to be entered into are not prejudicial to the interest of public shareholders, and that the terms and conditions of the RPTs are not unfavourable to the listed entity, when compared to the terms and conditions of similar transactions, when entered into with an unrelated party. It is reasonable to expect that the management of the listed entity will not routinely bring to the AC, transactions which are prejudicial to the interest of public shareholders. It is useful to remember that while examining arm's length pricing, the AC, even today, looks precisely at whether the transaction is in the interest of the company, and whether the pricing is appropriate, as compared to the pricing for unrelated parties. By way of an additional safeguard, Non-Independent Directors have been kept out of decision-making on RPTs. The minimum standards also provide that if any promoter Director does not provide such a certificate, the same shall be informed to the AC and to the shareholders, if it is a material RPT. It is difficult to envisage the possibility that a promoter Director will not provide such a certificate, since its absence could be fatal to the transaction in question.

In Clause (3) (2) (g), it is provided that in the case of payment of royalty, there should be a comparison with 3 industry peers, where feasible. The manner in which the payment of royalty should be dealt with, if the various alternatives listed for identifying industry peers are not available, leaves one to wonder whether this is an exercise which will involve disproportionate time, without yielding commensurate results. What is interesting is that if no suitable Indian listed or global industry peers are available, the listed entity may refer to the peer group considered by SEBI registered research analysts in their publicly available research reports. In a situation where neither Indian listed nor global industry peers are available, it leaves one to wonder how the SEBI registered analysts could constitute an appropriate peer group.

Clause 4 sets out the multipage format in which information is to be provided to the AC and to the shareholders. A few of the several items of information that are sought to be provided merit comment. In Section A (2), serial no. 5, it has been provided that the nature of the interest, whether direct or indirect, in the RP, should be brought out. This includes elements such as % of shareholding, % of contribution, and % of P&L sharing. Similarly, the % of shareholding of the RP in the listed entity, should also be brought up before the AC.

The financial performance of the RP for the previous 3 years is also to be detailed. These include the standalone turnover of the RP for each of the last 3 FYs, the standalone net worth of the RP for each of the last 3 FYs, and the standalone net profits for each of the last 3 FYs. How these would be relevant for a RP that is in existence, and is in a position to supply the goods or services, is a matter that needs to be thought through. Similarly, history of the previous transactions with the RP for the previous 3 FYs will also be required to be detailed.

In Section B (1), serial no. 7, it has been indicated that a certificate from the CEO or the CFO or any other KMP of the listed entity, and also from promoter Directors of the listed entity should be obtained to confirm that the transactions are not prejudicial to the interests of public shareholders, and that there is arm's length pricing. This being the central element to determine the appropriateness of an RPT, it is not clear why it has been tucked away in a long tabular statement, along with several other matters. What is interesting is that the management should provide a clear justification for entering into an RPT, demonstrating how the proposed RPT serves the best interests of the entity and its public shareholders.

In Section B (2), serial no. 15, it has been indicated that information regarding the additional cost/ potential loss (remember "presumptive loss") to the listed entity or the subsidiary in transacting with the RP, compared to the best bid/ quotation received, should be indicated. The AC is to justify the additional cost that the listed entity or the subsidiary has to incur. Indian corporate history is replete with instances of bidders making prima facie unsustainable bids to corporates, in order to get a contract, and then defaulting without any loss of time. Such developments disrupt the smooth business plans and production programmes of the listed entities. A listed entity's major concern would be that supply of goods and services by its vendors ensures product/ service quality, ability to adhere to timelines, and a non-disruptive supply of goods and services. Therefore, for good reasons, the management of a listed entity might choose to deal with RPs, even if the price involved is marginally higher, than the price offered by the lowest bidder. Some companies have a price band within which they could give a preference to the RP, secure in the knowledge, based on experience, that both product/service quality, and complying with timelines, can be counted on. To expect the AC, in each such case, to justify the non-acceptance of the lowest bid, is to ignore the fact that several ACs will not expose themselves to the risk of seeking to justify transactions with an RP at a higher price. In these challenging times, when Auditors and ACs are subject to increasing scrutiny, including judgement based on hindsight, some ACs might play safe, and prevent the best (as opposed to the lowest cost) transactions from going through. This clearly is not consistent with the conduct of business. The AC is also to comment on the adequacy of bids/ quotations if the number is less than 3. This brings back memories of the sham exercise of 3 quotations being received in some Government departments.

There are additional details required for transactions relating to loans, intercorporate deposits, and advances given by the listed entity or its subsidiaries. One item of information is the rate of interest at which RP is borrowing from its bankers, or the rate at which the RP may be able to borrow, given its credit rating, credit score, and its standing and financial position. Would it not be adequate to provide that the interest rate charged should not be less than what has been charged to an unrelated party?

There is also a provision for information relating to the dividend paid in the last 3 FYs as a % of net profits. The payment of dividend is to be made in accordance with the Dividend Distribution Policy of the company, and the company might well decide, with the understanding of the shareholders, that dividends would be limited, in order to plough back significant surplus, for expansion of business. Therefore, for the AC to comment on reasons for dividend payment being less than royalty payment is to compare 2 elements that belong in different spaces.

The minimum information guidelines also provide for making available information whether any in-house R&D undertaken by the listed entity or its subsidiary <u>will reduce</u> or eliminate the <u>royalty currently paid</u> for any technology or technical knowhow. Additionally, the absolute value of R&D expenditure incurred on such in-house R&D, along with the period required for completing the research to achieve reduction or elimination of royalty shall be disclosed to the AC. The AC is expected to provide comments, including justification, if no expenses were incurred. This provision has several problems. Firstly, there cannot be any compulsion for a company to undertake R&D,

and incur expenses. This is a long-term commitment that some companies might like to avoid or postpone. Secondly, the royalty is to be paid presently for technology or technical knowhow. R&D expenditure that might, in a few years, eliminate the need for technology or technical knowhow, is not going to address present day problems. All that the AC should be tasked to do is to decide on whether the expenditure presently being incurred by way of royalty payment is appropriate. Living in the hope of a successful R&D effort several years into the future, does not address the present requirements.

Clause 5 of the minimum information document sets out the information to be provided to shareholders for consideration of RPTs. It stipulates that the notice being sent to the shareholders, seeking approval for any material RPT, shall, in addition to the requirements under the Act, include 9 other items of information. These *inter alia* include the following.

- Statement of assessment by the AC that relevant disclosures for decision-making were placed before it, and it has determined that the promoters will not benefit from the RPTs, at the expense of public shareholders.
  Is it not sufficient that the AC and the Board recommend the transaction to the shareholders for approval, after taking into account all the relevant information.
- Copy of the valuation report or other reports of external party, if any, considered by the AC while approving the RPT. If the external party report is by itself a voluminous document, will the average shareholder have the time and/or the inclination to go through it, and to satisfy herself/himself that the external party's report satisfactorily addresses issues involved? It is akin to expecting a mutual fund investor to read the whole of a voluminous offer document before investing. Elsewhere in the minimum information guidelines there is a provision that the AC shall go through the report of the external party, and indicate, based on their independent evaluation, whether the basis for evaluation is satisfactory. Why then get an external party, and incur expenditure?

Is this a long procedural prescription to root out RPTs in the foreseeable future? If so, would it not have been preferable to state that RPTs will no longer be allowed, except in rare circumstances? Meanwhile, there is yet another consultation paper suggesting changes to some provisions relating to RPTs.

The previous month has also witnessed a few other developments which cannot be ignored. In one listed entity, following a protracted standoff between the Executive Chairperson and the major shareholder, the former has been finally eased out. Easing out of the Chairperson is not our major concern. Several other things however matter. Firstly, there is the unpreceded spectacle of a resolution being taken to the shareholder to state that the Executive Chairperson retires by rotation, and at the Annual General Meeting (AGM), the Chairperson stating that she is not required to retire by rotation. Was this not a matter that should have been sorted out in the boardroom? Is it for the shareholders to determine whether the Chairperson should retire by rotation, or stay indefinitely?

The role of Independent Directors (IDs) also gives rise to some concerns. They seem to have voted with the Executive Chairperson against the initial bid by the majority shareholder to acquire control of the company, on the ground that the price offered was not appropriate. However, by the time it came to the AGM, they seem to have decided that the Chairperson can be left well alone to fend for herself. No outside observer seems to be questioning the conduct of these IDs.

However, in another case of an entity where 4 IDs resigned in a matter of a few days, after a fraud came to notice, there have been claims for disgorgement of commission and the fees paid to them for attending meetings. In this case, what is amusing is that the 4 Directors resigned around the same time, giving completely different reasons, including old age, pre-occupation, and related

matters. Neither old age, nor pre-occupation happens overnight, when a fraud takes place in a company. To that extent, they are accountable for what has happened. However, is this disgorgement time, or should some other penal consequences, such as keeping them out of Boards, be the appropriate course? It is easy to conclude that the IDs were in the know of what was going on, and chose to turn a blind eye, till the matter came into public domain. If that is not the case, will not protection on the lines of Section 149(12) of the Act be available to them? The relevant question would be whether they got to know of the transgressions through a formal Board process, or whether their being diligent would have enabled them to spot the fraud being committed.

Separately, the Reserve Bank of India (RBI) has taken action against a co-operative bank because of a fraud committed by a former senior functionary of the bank. The fraud seems to have been perpetrated over a few years, and has not been one single act of transgression. How is it that annual inspections of RBI did not notice this problem? Questions would again arise whether any accountability ought to be attached for seeming negligence on the part of the regulatory authority that undertook the inspection.

One is increasingly reminded of the saying "When all is said and done, more will be said than done".

To view the minimum information guidelines, please click here

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