Related Party Transactions, Family Firms, and Regulation: Evidence from India[1]

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1.0 Introduction

Companies often engage with entities under their control or with familiar entities to substitute internal markets in order to reduce costs, increase efficiency and achieve optimal utilisation of resources. A Related Party Transaction (RPT) occurs in case of exchanges/transactions or deals between parties enjoying a pre-existing relationship, where either one of them has an interest in the other, exercises control over the other or both are controlled by the same entity. The transparency of pricing of assets being exchanged maybe questionable in such transactions because managers and controlling owners could expropriate wealth from minority shareholders (Cheung et al 2006, Berkman et al 2009). In his address at the National Academy of Audit and Accounts (NAAA), Shimla, the Governor of the Reserve Bank of India (RBI) drew attention to "instances of diversion of funds and / or transfer of profits to connected parties through various means – intra-group loans on favourable terms, over or under invoicing of transactions, asset transfers without fair valuation, etc" (Das 2021). He urged auditors "to identify and thoroughly scrutinise related or connected party transactions to ensure that there is no undue transfer of income or assets" (ibid).

However, RPTs can also be beneficial if they substitute internal markets resulting in cost savings, increased efficiency, and optimal utilisation of resources (Fisman and Khanna 2004). Consequently, RPTs need to be regulated but should not be banned. Many countries have adopted regulations to constrain expropriations through RPTs and protect minority shareholders.

[1] The authors gratefully acknowledge financial support from the NSE-NYU Stern Initiative on the Study of Indian Financial Markets. We thank Bernard Yeung, the Discussant at the NSE-NYU Conference, Mumbai, for his comments and suggestions.

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RPTs are regulated in India by the Companies Act 2013, the Indian Accounting Standards (Ind AS 18) and the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations (LODR). In 2018, following the recommendations of the Uday Kotak Committee, the SEBI expanded the definition of related party to include promoters with effect from May 9, 2018. The paper considers the impact of the 2018 regulation on the incidence, value and nature of RPTs taking into account the ownership structure of the firms. It also compares the impact of the regulatory changes in 2013, 2015 and 2018 and draws implications for the regulation that followed in 2021.

2.0 Institutional Setting

The Companies Act, 2013, the Indian Accounting Standard 18 (Ind AS 18), and the LODR 2021 govern RPTs in India. The Income Tax Act, 1961 also contains provisions on transfer pricing. The pre-2013 RPT regulations mandated disclosure but did not call for its approval by an independent organ of the corporation, say, independent board members who are not interested parties. After the Satyam Scandal (2008-09), the Companies Act 2013 moved closer to global standards by requiring the approval of disclosures by an independent organ of the company. In 2015, the SEBI amended Clause 49 of LODR to align it with the Companies Act, 2013. The Uday Kotak Committee that expanded the definition of related parties to include promoters marks the beginning of the third phase, while the fourth and current phase began in 2021 when the recommendations of a Working Group on RPTs were adopted by the SEBI in November 2021.

In this paper, we focus on the 2018 amendments in the LODR that introduced three changes. First, the SEBI mandated that "any person or entity belonging to the promoter or promoter group of the listed entity and holding 20 per cent or more of the shareholding in the listed entity shall be deemed to be a related party." Second, to increase transparency, the SEBI mandated the disclosure of RPTs on a consolidated basis in the annual accounts as per the accounting standards on the website of the listed entity within thirty days of publication of the half yearly financial results. Third, in line with the requirements of Companies Act 2013, the amendments require related parties to not vote in board meetings on material RPTs

involving them. We analyse the impact of regulatory changes in 2013, 2015 and 2018 on the incidence, value and type of RPT.

3.0 Data and Methodology

The paper is based on a sample of BSE listed non-financial private firms extracted from CMIE Prowess for the period between 2011-12 and 2021-22. This includes firms that carried out RPTs and those that did not. The data on RPT includes the type and value of RPTs. The transactions are further classified as expropriate (asset acquisition, asset sales, cash payments) and beneficial (cash and loan receipts), following Cheung (2006) and Bansal and Thenmozhi (2020). The regression analysis controls for firm characteristics including:

1. Ownership characteristics: Promoter holding, Nationality of the promoter, Business Group Affiliation
2. Governance characteristics: Board size, Percentage of independent directors, Whether external auditor is Big4 or not
3. Financial characteristics: Return on assets, Market capitalisation, Cash holdings, Leverage, PB ratio
4. Firm Age

We also account for industry and year specific effects. The main variable of interest is the regulatory change introduced in 2018.

The study comprises of two kinds of analysis. First, we consider the effect of 2018 RPT regulation on the probability of a firm's involvement in RPTs in a given year. This analysis is based on *logistic regression model*. Second, we consider the effect of 2018 regulation on the value of RPT normalized by total assets. This analysis is carried out using *Tobit* analysis which distinguishes firms between RPT and Non-RPT firms and then analyses the determinants of normalized RPT value.

4.0 Main Findings

I. Trend and Patterns in RPTs

The incidence of RPTs *reported* by BSE listed companies grew from a mere 1,064 in 2011-12 to 63,025 in 2021-22, where incidence refers to the number of related parties involved but each of them could potentially be involved in more than one transaction.

a. The manufacturing sector accounted for 57.45 per cent of the firms and 58.32 per cent of the RPTs. Among NIC sections, *Manufacturing* (60 per cent), *Wholesale and retail trade; repair of motor vehicles and motorcycles* (10 per cent), *Construction* (9 per cent) and *Information and communication* (7 per cent) accounted for most of the RPTs.
b. Two types of transactions - *Total revenue expenses/payments* (44.11 per cent) and *Total revenue receipts/income* (39.87 per cent) - accounted for almost 85 per cent of all the RPTs in our sample. These two also accounted for at least 70 per cent of the RPTs for each NIC category. *Outstanding guarantees taken/given* and *Guarantees taken/given during the year* account for between 5 and 20 per cent of the RPTs under most transaction types.

II. Determinants of Incidence of RPT

a. Promoter holding is associated with higher incidence of RPTs generally. However, less than 50 per cent of family holding is associated with a lower incidence of RPTs. When interacted with the dummy for the 2018 regulation, ownership levels below 20% show a positive and significant impact on the incidence of RPTs. Business groups are associated with a lower incidence of RPTs. Only fully foreign owned firms are associated with higher incidence of RPTs vis-à-vis fully Indian owned firms. We show that the 2018 amendments significantly reduced the value of RPTs in case of higher promoter holdings.
b. Board size has a significantly negative effect on the incidence of RPTs, while independent directors and auditors from among the Big 4 are associated with a higher incidence of RPTs.
c. Older firms and firms with larger market capitalization are more likely to be associated with a higher incidence of RPTs.

III. Determinants of RPT Value

a. Higher levels of promoter holding and affiliation to a business group are associated with higher normalized RPT value as these are associated with greater corporate control and opportunity for RPTs, respectively. Foreign ownership is associated with higher

normalized RPT values than Indian ownership. Mixed ownership, though, does not differ significantly vis-à-vis Indian ownership.

b. Board size is consistently associated with lower normalized RPT values, possibly due to collective action problems in larger boards. Contrary to expectations, independent directors do not have any significant impact on RPT value, while Big 4 auditors are associated with higher RPT values.
c. The age of firm is associated with lower normalized RPT value in most regressions, even though the coefficients are not significant in a few cases. Firms with larger market capitalization and higher leverage reported lower normalized RPT values. On the other hand, Cash holding, Returns on Asset and Price to Book ratio are associated with higher normalized RPT values.
d. Only two transaction types – *Guarantees taken during the year* and *Outstanding guarantees taken* – are associated with higher normalized RPT values than *Guarantees given during the year*, the base category. Beneficial RPTs (transaction types including Net outstanding current receivables, Total capital receipts and Total revenue receipts/income) are associated with higher normalized RPT values. These results are stronger in the post regulation period, suggesting regulations shifted firms toward more beneficial RPTs.

IV. Impact of regulations

a. The Companies Act, 2013 necessitated the approval of disclosures by an independent organ of the firm. In 2015, the SEBI amended Clause 49 of LODR to align it with the Companies Act, 2013. In 2018, the SEBI introduced stricter disclosure requirements and expanded the ambit of enforcement. Our findings show the 2018 regulations had a higher impact on the incidence of RPTs than earlier regulations.
b. The 2018 regulations reduced both incidence of reported RPTs as well as the mean value of RPTs normalized by total assets.
c. The 2018 regulations also altered the distribution of RPTs in favour of beneficial RPTs.

5.0 Policy Implications

The current sample allows us to capture the effect of only pre-2021 reforms. Our results show an increase in reporting of RPTs involving firms with less than 20 per cent promoter holding

after 2018. This possibly justifies the 2021 amendments to the LODR that reduce the threshold of promoter holding for the identification of related parties from 20 to 10 per cent.

The SEBI introduced the fourth phase of regulation in 2021. Under the new regulations, promoters with more than 10% ownership are included as related parties, the threshold of lower of ₹1,000 crore or 10% of the consolidated annual turnover of the listed entity for shareholder approval. for shareholder approval requirement has been included, the definition of RPT has been expanded to cover more transactions between related parties, the scope of audit committee has been increased and the disclosure requirements have been made stringent. The full impact of the changes adopted by SEBI over the last decade will become clear only after the latest amendments to the LODR are implemented in 2023-24.

A few gaps remain to be addressed even in the revised regulations. The audit committee is left to determine what constitutes 'material modification', which could be a source of subjectivity. There is also some conflict between overlapping regulations, with the SEBI defining materiality in terms of turnover and the Companies Act defining it in terms of net worth. Finally, according to the SEBI, an RPT is a transaction with the 'purpose and effect' of 'benefitting a related party of the listed entity or any of its subsidiaries', though it is unclear how this will be evaluated by the audit committee.

6.0 Way forward

There are four lines of inquiry that merit further research. First, the impact of RPT on firm value across family and non-family firms can be assessed using accounting measures like ROA, Tobin's Q, and PAT. Second, the effect of the timing of public disclosure of the RPT can be assessed by examining the impact of disclosure on the short term cumulative abnormal returns. Third, the impact of regulatory changes introduced in 2021 on RPTs needs to be examined. Fourth, ownership alone is not sufficient to understand family firms, the nature of management and the distribution of shareholding also matter. So, an examination of the impact of management structure on RPT is required.

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