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An Analysis of Related-Party Transactions in India¹

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Abstract

Related-party transactions (RPTs) refer to transactions between a company and its related entities such as subsidiaries, associates, joint ventures, substantial shareholders, executives, directors and their relatives, or entities owned or controlled by its executives, directors, and their families. RPTs are widespread and are part of every business group activity. RPTs have come under close scrutiny in recent years as they have been misused by companies as revealed in various corporate scandals. The study analyses Indian companies for three years between 2009 and 2011 and finds that RPTs were widespread and present in almost all companies during this period. Further, companies with high RPTs related to sales and income were found to report lower performance compared to companies with low RPTs. While ownership structure failed to offer any explanation for the magnitude of RPTs, RPTs were found to be lower in companies where big audit firms were statutory auditors.

Keywords: Related party transactions, Corporate governance, Indian companies

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1 Introduction

A related-party transaction (RPT) refers to a transaction between two parties who are joined by a special relationship prior to the transaction; the transaction could be a business deal, a single or a series of financial contracts, or an arrangement. The parties involved on the two sides of the deal could be a parent company and its subsidiaries or affiliates, the employees, the principal owners, the directors or the management of the company and the subsidiaries, or members of their immediate families. Indian Accounting Standards (AS-18) considers parties to be related to each other “if one party has the ability to control or significantly influence the other in making financial and/or operating decisions in a particular reporting period”. The control on a related party may be exercised either directly or indirectly through one or more intermediaries or other entities that are controlled by its key management personnel or their relatives.

Several scandals in the U.S. and other parts of the world have cited RPTs as a means to manage earnings as well as divert resources from their companies. Accounting frauds in Enron, Tyco, Parmalat, and Satyam are glaring examples of the same. The potential to abuse RPTs is a cause for concern all over the world to both regulators as well as investors. If RPT is widespread and misused, it may lead to serious consequences. RPTs not only reduce the returns to outside shareholder but also raise doubts on the effectiveness of corporate governance, which in turn hinders growth in the equity market and the overall economic progress of a country.

A related-party transaction can also play a beneficial role by saving transaction costs and improving the operating efficiency of a company. In other words, all RPTs are not abusive. In fact, there may be several such transactions that are unavoidable because they make commercial sense for the company; if companies are prohibited from entering into such transactions, it might work against the principle of maximising the shareholder value. For example, when group companies work within the context of institutional voids,² they can make use of RPTs to achieve effective asset utilisation as well as to reduce transaction costs when they integrate for strategic purposes (Khanna and Palepu, 2000; Khanna and Rivkin, 2001; Chang and Hong, 2002; Mahmood and Mitchell, 2004; Belzon and Berkovitz, 2010). Further, they enable member firms to share risks by transferring income flows and reallocating money from one affiliate to another wherever needed (Lincoln et al., 1996; Fisman and Wang, 2010).

² Institutional voids represent the lack of intermediaries and others in labour and capital markets that prevent the smooth functioning of the markets, especially in economically and institutionally underdeveloped emerging markets.

Keister (1998) observed that group affiliation improved productivity and financial performance among Chinese firms in the 1980s. Many multinational companies operating outside their parent countries have business models that involve RPTs. The parent companies bring in technology and know-how as well as financial assistance to the subsidiaries as and when needed (Khanna and Yafeh, 2005). Companies may start a new business that is integral to the company through a different entity in order to curtail the risk of the investing company. Lincoln et al. (1996) find that business group affiliations help to reduce the bankruptcy risks for member firms such that the performance of the group-affiliated firms experiences less volatility than that of independent firms in Japan.

However, not all RPTs are beneficial to investors. Transactions involving related parties are not considered to be at an arms-length basis. Though they are not illegal, the intricacies underlying them are difficult to identify. Companies often indulge in RPTs to manage their earnings or to siphon off the assets of listed companies to other affiliated firms. Other RPTs include granting loans, writing off loans and dues, selling assets to a related entity for a price significantly below the market price, and so on. Such RPTs are usually indulged in by dominant shareholders, who have significant control rights compared to their cash flow rights, creating a strong incentive to expropriate the minority (absentee) shareholders. In a situation where control rights are higher than cash flow rights and the enforcement systems are weak, one can presume a high level of RPTs.

Many high-profile accounting frauds in recent years (such as Enron, Adelphia, Tyco, and Satyam Computers, to name a few) have involved RPTs in one way or the other. The Tanzi family that controlled the Parmalat group tunneled out billions of dollars from the group companies into other companies that were directly owned by the family (Enriques and Volpin, 2007).

Anecdotal evidence and academic studies show that the transfer of resources by overpaying for the acquisition of assets, hiding losses, and understating debts in their financial statements to cover up the fraud are quite widespread practices. The use of RPTs is prevalent all over the world. Some of the studies that report the presence of RPT in different countries include Atanasov et al. (2010): Bulgaria; Baek et al. (2004): South Korea; Bergström and Rydqvist (1990): Sweden; Bertrand et al. (2002): India; Cheung et al. (2006): Hong Kong; Gao and Kling (2008): China; and Weinstein and Yafeh (1995): Japan.

Adverse RPT reduces transparency in reporting, decreases the value of the firm, and stunts the growth of the capital markets ultimately. Gordon et al. (2004) examined the relationship of RPTs in the U.S. and found that abnormal stock market yields were negatively correlated with RPTs. Analysing data from 1261 firms of S&P 1500, Kohlbeck and Mayhew (2010) found that firms indulging in RPTs had lower valuation and lower subsequent returns compared to firms that did not. Gopalan et al. (2007) found that Indian investors and creditors were aware of the propensity among group-affiliated firms to transfer financial resources to other group companies that are inefficient and to transfer funds through inter-corporate loans if they were incapable of raising capital. These transactions not only erode the value of the firm (Peng et al., 2011) but also lead to bankruptcy and ultimate collapse. The recent failure of Satyam Computers is a glaring example of perpetrating fraud and covering up through RPTs.

Despite the importance of the topic, academic studies use indirect proxies to examine potential RPT transactions and their impact. There are relatively few papers that study the methods of the transactions through which expropriation occurs. Further, not many studies have attempted to provide evidence related to the consequences of RPTs in India although anecdotal evidence indicates that RPTs are being used to manipulate earnings and expropriate minority shareholders. Studying RPTs is also important as investor protection available from self-serving transactions is low. Further, governance mechanisms such as independent directors and audit committees have still not proved their effectiveness, particularly when there is concentrated ownership. While companies disclose their RPTs, the content, format, and transparency of these disclosures have not been examined before. Appropriate and adequate scrutiny of RPTs therefore, becomes important, particularly to the regulators and minority shareholders. This study is motivated by the need to understand and analyse RPTs in India.

The primary objective of this exploratory study is to document the level of RPTs in companies. In addition, the study examines what influences RPTs and how RPTs affect performance. Companies that are part of the BSE 200 index form the initial sample to explore the role of RPTs. In particular, the study sets out to do the following:

- Revisit the regulatory framework on RPTs.
- Make a detailed analysis of the nature and frequency of RPTs.
- Analyse the existing literature on RPTs and identify the questions that need to be examined.

- Study the impact of RPTs on firms' operating performance and further examine the effect of certain governance factors that influence RPTs.

The study contributes to the existing literature on RPTs by examining the transparency of disclosure as well as its impact on the operational performance of Indian companies. The remaining part of the paper is organised as follows. In Section 2, we discuss the regulatory framework. Section 3 discusses the literature and presents the hypotheses. In Section 4, we discuss the methodology and data. Section 5 reports and discusses the results; in the last section, we conclude and give our recommendations.

2 Related-Party Transactions: The regulatory framework

Over the last decade, corporate governance has attained importance around the world. Indian regulators closely follow corporate governance developments around the world and periodically introduce some of the best practices followed or introduced in other countries. Clause 49 of the Listing Agreement between a company and a stock exchange has mandated several governance regulations and disclosures for companies listed in Indian stock exchanges. Greater focus has been placed by both academicians as well as regulators on the issue of investor protection, particularly that of the minority shareholders. Controlling shareholders/managers indulge in various forms of such self-dealings, such as executive perquisites, excessive compensation, transfer pricing, appropriation of corporate opportunities, and self-serving financial transactions such as directed equity issuance or loans to insiders, and misappropriation of corporate assets (Shleifer and Vishny, 1997). Regulators all over the world have proactively taken steps to monitor and prevent such self-dealings in the form of disclosures, approvals, or even outright bans on such transactions. OECD has also provided guidelines on legislative and regulatory approaches for monitoring and preventing abusive related party (OECD, 2009). The disclosure of an entity's transactions, outstanding balances (including commitments), and relationships with related parties are important for the investor. This will enable the investor to effectively assess the financials and the financial statements of the entity including assessments of the risks and opportunities facing the entity. Regulations related to RPTs are found in the Companies Act, 1956, the Indian Accounting Standard 18 (Ind AS 18), the Auditors Report Order, and Clause 49 of the Listing Agreement. The Income Tax Act 1961 also contains provisions related to transfer pricing issues on such transactions. These regulations are briefly discussed in the following sections.

2.1 The Companies Act, 1956

The Companies Act, 1956 governs companies in India. Prior to the amendment in 1999, the Companies Act had provided limits on investments beyond a certain prescribed percentage (of the aggregate of the subscribed capital of the lending company and its free reserves) by a company in other bodies corporate, whether in the same group or outside the group (Sections 372 and 370). Similar limits applied to inter-corporate loans as well as loans that could be advanced to companies in the same group. After passing a special resolution in the general meeting, an approval from the Central Government was mandated if the loans were to exceed specified limits (Ramaiya, 1988).³ Subsequently, the law was amended and Section 372A was introduced. This provision now applies to include inter-corporate loans and deposits, investments, guarantees, and securities in connection with loans to another public body corporate. The present law sets limits based on the total paid-up capital and/or free reserves, and these transactions are subject to approval by the board and with the consent of all the directors present at the meeting. Any transaction in excess of the specified limit requires an approval at the annual general meeting through a special resolution. This section is not applicable to loans given to an individual, firm, trust, or a mutual fund. The limits do not apply to investments in shares allotted pursuant to Section 81(1)(a) and to “loans by holding companies to its wholly owned subsidiary, guarantees/securities by holding companies for loans to its wholly owned subsidiary and investments in securities by holding company of its wholly owned subsidiary”. Under Sections 297, 299, and 314(1A), the Act lays down certain procedures to be followed before an RPT is entered into. Board sanction is required if a director 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 enters into a contract with the company (a) for the sale, purchase, or supply of any goods, materials, or services; (b) for underwriting the subscription of any shares in the company; or (c) for debentures of the company. Board sanction is not needed if the purchase/sale is for cash at prevailing market prices. Section 299 requires the disclosure of interest by a director in a board meeting in case the director is interested in any contract that the company is proposing to enter into.

³ The Vivian Bose Commission (1962), on whose recommendations loans were included, states: “In these cases, it was always the public companies that suffered and the investing public along with them. The wrong lay in *the fact that those who* were in control wrested improper advantage for themselves from the companies that they controlled and let the companies under their control suffer” (Ramaiya, 1988).

2.2 Indian Accounting Standard 18

The Indian Accounting Standard 18 (Ind AS 18) covers the disclosure requirement of RPTs. Parties are considered to be related if one party has the ability to control the other party or if one party can significantly influence the other in making financial and/or operating decisions in a particular reporting period. The Ind AS 18 does not mandate a specific format for reporting RPTs. It gives a provision for aggregating these transactions when they are too numerous. Only those transactions that pass the materiality test—those that are 10% or in excess of the monetary value of the total transactions of the same nature—are exempted from aggregation. The requirement of disclosure includes (i) the name of the transacting related party; (ii) a description of the relationship between the parties; (iii) a description of the nature of transactions; (iv) the volume of the transactions either as an amount or as an appropriate proportion; (v) any other elements of the RPTs necessary or an understanding of the financial statements; and (vi) the amounts or appropriate proportions of outstanding items.

2.3 Clause 49 of the Listing Agreement

Clause 49 of the Listing Agreement requires that the details of material individual transactions with related parties that are not in the normal course of business along with a statement of all RPTs should be placed before the audit committee.

In this context, it may be useful to highlight the key RPT Regulations in the U.S. Under the Sarbanes Oxley Act 2002, public companies are prohibited from making or arranging for personal loans to any director or executive officer. The NASDAQ also requires that the audit committee or another committee of independent directors reviews and approves all RPTs. Further, the Securities Exchange Commission (SEC) requires a disclosure (in non –financial statement) of director compensation and of transactions in excess of USD 120,000 in which a related person, has a direct or indirect material interest (SEC Regulation S-K, Item 404). The US GAAP requires material RPTs to be disclosed) although the place of disclosure is not mentioned. There is no requirement in the U.S. for shareholder approval of RPTs as in India. However, the U.S. has strong legal provisions that enable investors to take legal actions against abusive related-party transactions (Djankov et al., 2008).

3 Literature Review and Conceptual Framework

Earlier research on corporate governance concentrated mainly on the principal agency problem. The seminal work of Berle and Means (1932) argued that firms with a dispersed ownership structure enabled the opportunistic behaviour of managers, creating conflicts particularly in the Anglo-American capital markets. In contrast, managers' self-serving behaviour was prevented if there was concentrated ownership, where owners oversaw the managers and avoided agency cost (Jensen and Meckling, 1976).

In most parts of the world, ownership is concentrated in the hands of the controlling shareholders (La Porta et al., 1999; Claessens et al., 2000). In such cases, the agency problem arises from conflicts between the controlling and the minority shareholders. Controlling shareholders are incentivised to expropriate firm resources to pursue their own interests at the cost of those of the minority shareholders mainly through RPTs (Bertrand et al., 2002; Lemmon and Lins, 2003). Controlling shareholders derive private benefits at the cost of the other shareholders through transactions such as the sale or transfer of assets (at lower value), the purchase of assets (at higher value), and the sale of goods or services to other entities under their control at prices that are not at arm's length. In addition, they can acquire additional shares at a preferential price, obtain interest-free loans, or have trading relationships on cash payments that are likely to result in the expropriation of the minority shareholders (Johnson et al., 2000; Atanasov, 2006; Cheung et al., 2006).

The effect of RPTs on the performance of companies is mixed. These transactions—also termed as “tunnelling” by Johnson et al. (2000)—have the potential to siphon off wealth and are routed through related parties where the dominant shareholder has high cash flow rights. Many previous studies have noted that when a controlling shareholder uses RPTs to siphon off a company's resources, it has a negative impact on the corporate value (Claessens and Fan, 2002). Chen et al. (2009) showed that in China, when a listed company is controlled by a related party, the higher the level of RPTs, the worse is the operational performance of the company. RPTs involving sales, loans, guarantees and mortgages, or leases have been found to contribute to the reduction in performance.

Recent studies have shown the use of RPTs for a variety of other purposes. In China, abnormally high levels of related-party sales are made—mainly to their controlling shareholders and other member firms in the group—when they have incentives to inflate earnings to avoid being delisted or

prior to issuing new equity issue (Jian and Wong, 2004). RPTs have been used for “propping” the operational performance of the firm. Group companies in China use RPTs extensively to achieve the level of return on equity (ROE) (Chen and Yuan, 2004; Liu and Lu, 2007). Chen et al. (2011) examined the impact of RPT-based earnings management on the operational performance of listed companies prior to stock market listing with operational performance after listing and find that RPT does affect the performance. Earlier studies on Indian data showed that performance was negatively associated with the extent of RPTs for group firms, but positively for stand-alone companies, supporting the tunnelling hypothesis (Saha, 2006).

Some studies (such as Cheung et al., 2006) reported that no explicit link is proved between RPT or tunnelling and the value of the firm; such studies concluded that investors are myopic and systematically underestimate the risk of tunnelling and expropriation. Villalonga and Amit (2008) argued that the reaction of the market to tunnelling potential depends on the mechanism that is used by the dominant family (or block holder) to enhance control. Khanna and Yafeh (2005) found that business group members shared the risks experienced by individual members and showed that the operating profitability levels of group-affiliated firms are less volatile than those of unaffiliated firms in some countries such as South Korea. Expropriation has implications in the long run as it will result in loss of earnings for minority shareholders, directly affecting the operational performance of the firm.

The preceding discussion leads to the following hypothesis:

H1: RPTs will negatively affect the company’s operating performance measured by return on assets.

RPTs are more likely to occur in companies where a few shareholders have control over the affairs of the company, which gives them an opportunity to expropriate the minority shareholders (Claessens et al., 2000; Cheung et al., 2006; Nekhili and Cherif, 2011). There is also evidence to suggest that the likelihood of RPTs is greater among firms in which ownership is concentrated in the hands of block holders such as families (Fan and Wong, 2002). Indian companies have highly concentrated ownership structures and have greater control rights than cash flow rights. Hence, we posit the second hypothesis as follows:

H2: Related-party transactions are more frequent in companies with higher concentrated ownership.

RPTs create a burden on the financial resources of a company, affect the optimum allocation of resources, and lead to unethical practices affecting the minority shareholders. RPTs are not observable by the market participants and are hence difficult to monitor externally. Hence, good governance mechanisms are required to monitor these transactions. Independent directors have a role to play in overseeing the transparency of information as well as in implementing internal controls in organisations. A company having more independent directors on the board would limit the adverse effect of RPTs. Thus, our third hypothesis is as follows:

H3: The presence of more independent directors on the board will limit related-party transactions.

Statutory auditors have access to the transactions of the company. The presence of the statutory auditor, especially big auditors, may act as a check on RPTs. Big four auditors have greater information and bring specialised expertise of auditing companies around the world. Companies audited by big auditors also adopt greater transparency (Mitton, 2002). As the big auditors' reputation is involved, they would be more careful in examining these transactions. However, the lack of independence may limit the effect of auditors on RPTs. The fourth hypothesis is as follows:

H4: Big auditors will have a restraining effect on RPTs.

Foreign investors include the foreign institutional investors (FIIs) as well as the American and Global Depository holders who are shareholders in many Indian companies. Foreign investors will normally invest in companies that have less group affiliates, i.e., concentrated ownership, because of problems in monitoring. Nevertheless, when they invest in group companies, they will invest in groups that are more transparent. Hence, FIIs will serve as a valuable monitoring institution in emerging markets. Foreign investors will also serve as a validation to the RPTs of companies. Companies that are listed in the international stock exchanges face additional pressures for disclosures, which may deter them from RPTs. Thus, the last hypothesis is as follows:

H5: Higher FII involvement will deter RPTs.

Although these hypotheses should ideally be tested using abusive RPTs, because of the absence of data relating to abusive RPTs, the above hypotheses have been tested for all RPTs. We believe that the results would still be instructive.

4 Sample and Methodology

This section describes the sample population used for the study and the methodology adopted.

4.1 Sample

The sample consisted of companies that were part of the BSE 200 at least once during the three years between 2008–2009 and 2010–2011. These were the most recent years for which data was available. This resulted in 246 companies. All banks and financial services companies were eliminated from the list as banks are exempted from disclosure of RPTs. Further, state-owned enterprises (public sector undertakings) were also exempted from disclosing transactions with other government enterprises, and hence were not included in the sample. The final list for analysis consisted of 171 companies. The sample contained large firms from different industries with a variety of ownership structures.

The data was hand-collected from the annual reports of the companies. Although hand collection of data involved spending more time, it allowed a detailed study of the disclosure levels of the companies. Databases such as Capitaline and Prowess provide data on RPTs, but there were several limitations. A few test comparisons showed that a number of transactions reported were labelled differently in the databases as compared to the annual reports. Also, a large number of items were combined and grouped differently. Many transactions were reported as “other transactions” or “transactions not specified”. The databases also showed limited categorisation of related parties. Hence, it was decided to collect RPT data only from the annual report. Annual reports were downloaded from each company’s website for this purpose.

In order to minimise any inconsistencies in the measurement process, the annual reports were analysed twice to ensure that the RPTs disclosed and recorded were the same in both the cases. At the first instance, the entire report was scrutinised and coded. Subsequently, items that were not relevant or were not easy to classify were identified. This method has been suggested in earlier research. Data for the regression was downloaded from the Centre for Monitoring the Indian

Economy (CMIE) database. The database has been extensively used by researchers and academia all over the world for data on Indian companies.

4.2 Descriptive Analysis

The average market capitalisation of the firms that were studied ranged from INR 9467 crore in 2009 to INR 20,259 crore in 2011, indicating the presence of large companies. Table 1 gives the general descriptive statistics of the sample.

Table 1: General Statistics of Sales, PAT, and Market Capitalisation (in INR crore)

Variable	Statistics	2009	2010	2011
Income	Mean	6429	7289	8746
	STDEV	13291	17336	22047
	Max	148427	203626	262161
PAT	Mean	675	787	945
	STDEV	1599	1743	2243
	Max	15309	16235	20286
Market Capitalisation	Mean	9467	18642	20259
Related-Party Transactions*	Total	477857	552793	613761

Source: CMIE Database

*RPT Source: Annual reports of companies in the sample

4.3 Reporting of RPTs

The disclosure of RPTs in the annual report was not uniform across companies; some of the issues observed are discussed in this section. Not all companies reported the names of the related parties and the relationships, the type of transaction (sale/purchase, etc.), and the amounts. Some companies reported the related-party relationship (subsidiary/associate, etc.) along with the above, while others did not report the relationship in one place. The types of transactions were not uniform. Some companies did not clearly mention the transactions. For example, under “Loans”, some companies were silent about whether the loan had been given or taken. Similarly, “Funds Transferred” and “Expenses Reimbursed” were a few items where the direction of the transactions was not mentioned. There were several cases where joint ventures and associates were clubbed together. In the absence of a standard format, companies followed their own style, making it difficult for any analysis without first setting the data in an orderly manner.

4.4 Analysis of RPTs

There were 7846 related parties reported by the sample firms in 2011. Of these, transactions were reported for 7337 parties. There were 95 holding companies, 674 key management personnel, 3662 subsidiaries, and 2844 others (including associates, relatives of key personnel, etc.). While the companies reported 18 types of related parties, we combined some of them for ease of analysis. The list of related parties is given in Appendix 1.

More than 220 types of transactions occurred with various related parties. The types of transactions included giving/taking loans and advances, sale/purchase of goods, payment of royalty, income from services to related parties, and so on. Appendix 2 gives an illustrative list of a few transactions.

All the RPTs were further classified into 10 categories based on the nature of transactions. Items related to outstanding or balances and reversal of the primary transaction were not included as RPTs. Some transactions that were accounted twice are considered only once for the analysis; i.e., loans given and received back were accounted only once though some companies showed the transactions twice. The disclosures of a few companies are given in Appendix 3.

4.4.1 Frequency of RPTs

In 2011, 80% of the reporting companies (137 companies) had transactions with subsidiary companies; 80 companies (46.78%) had transactions with associates. Almost all the companies had transactions with key management personnel (KMP), mainly due to remuneration paid. The number of companies having transactions with holding companies increased from 2009 to 2011. Table 2 gives the number of companies having transactions with various related parties.

Table 2: Number and Percentage of Companies Having Transactions with Different Related Parties

Year	Associates	Holding Company	Joint Venture	Subsidiaries	Others*
2009	72 (42%)	47 (27%)	59 (34%)	143 (83%)	162 (94%)
2010	76 (44%)	83 (48%)	63 (36%)	137 (80%)	162 (94%)
2011	80 (46%)	85 (49%)	62 (36%)	137 (80%)	160 (93%)

Source: Data collected from annual reports

* “Others” include fellow subsidiaries, key shareholder control, relatives of key management personnel, partnership firms, AOP, and any other related parties indicated as others.

4.4.2 Nature of RPTs

Although the sample firms had a number of RPTs of a different nature, the three major transactions were income, expenses, and loans and deposits. While expenses on average (for the three years) accounted for 18.2% of all RPTs, income and loans and deposits accounted for 20.8 % and 24%, respectively. The purchase of goods and material and the payment for services were the major component of expenses. Table 3 shows the value of RPTs under different heads.

Table 3: Total Value of Related-Party Transactions (in INR crore)

Transactions	2009	%	2010	%	2011	%	Average%
Loans & Deposits Given	116020	24.2	149676	27.0	126984	20.6	24.0
Income	100526	21.0	105736	19.1	135832	22.1	20.7
Expenses	76938	16.1	111728	20.2	111984	18.2	18.1
Investment in Shares and others	65384	13.6	51653	9.3	73915	12.0	11.6
Bank Guarantee Given	69169	14.4	45337	8.2	50745	8.2	10.3
Loans & Liability Bank Guarantee Received	11578	2.4	43807	7.9	55140	8.9	6.4
Dividend Payment	23470	4.9	25258	4.5	30802	5.0	4.8
Fixed Assets Purchase/Sale	5595	1.1	8716	1.5	10740	1.7	1.5
Share Capital	6680	1.4	5601	1.0	12154	1.9	1.4
Total	477857	100%	552793	100%	613761	100%	100%

Source: Data collected from annual reports

4.4.3 Transactions with Related Parties

Transactions with subsidiary companies accounted for 64% (average) of all the RPTs. Other prominent related parties with whom transactions were held were associates (8.36%) and holding companies (8.73%). Transactions with others included those with key management personnel and others. The percentage and value of transactions with related parties are given in Table 4.

Table 4: Value of Transactions with Each Related Party (in INR crore)

Party	2009 Amount	%	2010 Amount	%	2011 Amount	%	Average %
Subsidiary	330760	69.2	335372	60.6	388511	63.3	64.4

Holding	19502	4.0	69283	12.5	58795	9.5	8.7
Associate	41401	8.6	45420	8.2	50362	8.2	8.3
JV	16988	3.5	20329	3.6	22931	3.7	3.6
Others	69206	14.4	82389	14.9	93162	15.1	14.8
Total	477857	100.0	552793	100.0	613761	100.0	-

Source: Data collected from annual reports

Transactions with subsidiaries primarily consisted of loans given and income transactions. Expenses—payment for goods, royalty, and other expenses—formed the major transaction with associates and holding companies as well as with JVs. Sales to associates, holdings, and JVs formed the next highest transaction. Dividend payment was made to holding companies. Apart from loans and advances, transactions in the nature of providing bank guarantees were prevalent RPTs. These guarantees were provided to subsidiary companies. Bank guarantees were mainly received from the key management personnel/controlling shareholder.

Table 5: Details of Loans and Advances (in INR crore)

Particulars/RPT	Year	Associates	Holding	JV	Subsidiary	Others
Loans and Advances	2009	1074	12	1903	50978	3452
	2010	9079	3494	1500	104987	13684
	2011	1732	1532	1258	94689	14890
Bank Guarantee	2009	5072	522	1055	56747	2901
	2010	5716	4201	259	34778	389
	2011	5616	1553	129	43067	383

Source: Data collected from annual reports

5 Firm Performance, Governance Structure, and RPTs

The presence of RPTs in large volumes among Indian companies was noted in the previous section. The impact of RPTs on the operational performance of the company is examined in this section. The empirical model used in earlier studies such as Chen and Yuan (2004), and Chen et al. (2009) was followed. The operational performance of the firm was measured by return on assets (ROA). ROA has been used extensively in the extant literature as an indicator to measure the net return made by a company on the assets it has invested in.

RPTs were grouped into three broad categories, namely income, expenses, loans and bank guarantees. Related-party expenses included purchase of goods, receipt of services, and expenses.

Loans and advances were transactions that involved giving funds to related parties, including guarantees.

Each of the independent variables was taken as a percentage of the relevant item in the company so that it could measure the intensity of the RPT. Related-party loans and guarantees as a proportion of the total assets was used as an independent variable. The return variables were affected by other variables, particularly size and leverage. Debt to total assets (LEV) and the growth variable (GRTH) were used as additional control variables to capture the size effect as well as the industry effect.

Panel data regression was performed to find the relationship between RPT and the performance of firm:

$$ROA_{it} = \alpha + \beta_1 RP_INC_{it} + \beta_2 RP_EXP_{it} + \beta_3 RP_LABG + \beta_5 GROWTH_{it} + \beta_6 LEV_{it} + \varepsilon_{it} \quad (1)$$

where ROA_{it} is the return on assets of a firm in period t ; RP_INC_{it} is the related party income divided by the total income of the firm in period t ; RP_EXP_{it} is the total related party expenses as a percentage of the total expenses of the firm in period t ; RP_LABG includes both bank guarantees as well as loans to related parties as a percentage of the total assets of the firm in period t ; $GROWTH_{it}$ is the market capitalisation of the firm divided by assets in period t ; and LEV_{it} is the ratio debt of a firm to total assets in period t .

Table 6 presents the results of the impact of various RPTs on the operational performance as measured by ROA. There is a significant negative correlation between the performance of the company and related-party expenses as well as income. This means that the higher the RPTs, the lower the operational performance of the company. The impact of loans and bank guarantees on performance was not significant although it is negative in sign. The empirical results support Hypothesis 1.

Table 6: ROA and RPT variables

Independent Variables	Coefficient	t-Value
Constant	0.0943	4.4***
RP_Exp	-0.0018	-2.74***
RP_INC	-0.0128	-2.7***
RP_LABG	-0.0326	-1.81*
LEV	-0.0533	-0.87
Growth	0.0135	2.79***

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

Do the ownership patterns and governance mechanisms of a company influence the size of the company's RPTs?⁴ This relationship was examined through panel data regression:

$$RPTI_{it} = \alpha + \beta_1 PR_OWN_{it} + \beta_2 FII_OWN_{it} + \beta_3 BIGAUD_{it} + \beta_4 IDIR_{it} + \varepsilon_{it} \quad (2)$$

where $RPTI_{it}$ index measures the intensity of RPTs; PR_OWN_{it} measures the promoter ownership percentage to total ownership; FII_OWN_{it} measures the percentage of foreign institutional ownership; $IDIR_{it}$ measures the percentage of independent directors to the total number of directors in the firm; and dummy values (1 and 0) are used for the presence or the absence of $BIGAUD_{it}$.

Table 7 presents the empirical results of the second regression. We found that none of the explanatory governance variables were significant. These results are different from the results reported in Wahab et al. (2011). However, a big external auditor had a negative effect on RPTs, implying that an external monitor is better than internal governance mechanisms.

⁴ The average of the promoter holdings for the sample companies was 50.76% and the maximum was 87.15% during the sample years. The average FII investment was 13.08%. The maximum percentage of independent directors on the board was 78% with an average of 47%. Big 4 and their affiliates had audited 46% of the sample firms. Indian companies accounted for 84% of the sample companies.

Table 7: Empirical Results for Equation 2 for Various Variables to RPTs

Independent Variables	Coefficient	t-Value
Constant	.462	1.602
PR_OWN	0.006	1.335
FII_OWN	-0.003	-0.369
BIGAUD	-0.290	-1.752*
IDIR	-0.006	-0.200

*** Significant at 1% level; ** Significant at 5% level; * Significant at 10% level

6 Conclusion and Suggestions

This paper addresses a crucial corporate governance issue of related-party transactions—in an emerging market economy such as India. After revisiting the regulatory framework and existing literature on RPTs, the paper presents an exhaustive analysis of the nature and type of RPTs in some of India’s top companies during the period 2008–2009 to 2010–2011 as well as their effect on the performance of those companies. One of the main findings of the study is that there are deficiencies in the RPT disclosure requirement.

The study identifies five questions (as posed through hypotheses) that need to be examined. The unavailability of data on abusive RPTs compelled us to test the hypotheses using the reported RPTs. Despite this shortcoming, the paper contributes to the existing literature on RPTs with some very useful results in the Indian context. The empirical results suggest that performance measured by ROA is negatively impacted by RPTs. The results are significant for both income as well as expenses. Loans and bank guarantees also impact the performance negatively, though the results are insignificant. Ownership structure, FIIs, and independent directors are not associated with RPTs. However, the presence of big auditors tends to control RPTs.

While it is widely acknowledged that clarity in the regulations related to RPT disclosure requirements acts as a deterrent to abusive transactions, considerable variations in RPT-related disclosure among companies was found in the study, which indicates the need for some broad structure and clarity in the reporting requirements. The accounting standards can provide additional guidelines for the reporting of RPTs. Time intervals of disclosure are equally relevant and important. Currently, RPTs are part of an annual report that reaches investors with a huge time lag—only at the

end of the accounting year. Companies may be asked to file major RPTs with the stock exchange at a greater frequency (quarterly/monthly basis, for instance) as it is done in some other countries.⁵

One indirect implication of the study is that the audit process has an important bearing on the RPTs. It is, therefore, suggested that the board of directors and the audit committee must play a proactive role in related-party agreements. They must put in place a policy for entering into RPTs and for the periodic monitoring of all material RPTs. Auditors can play a crucial role in revealing RPTs that are detrimental to the investors. However, the auditors' dependence on the management for getting all the information related to RPTs can potentially thwart this prospect. A special audit guidance note on RPTs would be useful in this respect.

⁵ For example, the Material Definitive Agreement has to be disclosed to the Securities Exchange Commission in the U.S. within four days of entering the agreement.

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Appendix 1

List of Related Parties Reported by Companies

Holding companies
Subsidiaries/Sub-subsidiaries (Step-down subsidiaries)
Fellow subsidiaries
Enterprises under common control
Associates
Key management personnel
Relatives of key management personnel
Joint ventures/Joint ventures of subsidiary
Entities where control or significant influence exists
Entities having control or significant influence over reporting company
Partnerships/Partnerships of subsidiaries
Association of persons
Unincorporated joint ventures
Jointly controlled entities
Integrated joint ventures
Promoter group
Entities where key management personnel or their relatives have control/significant influence
Parties having substantial interest
Affiliates
Trustee in board of trust
Controlling shareholder and relatives of controlling shareholder
Others

Source: Data collected from annual reports

Appendix 2

Different Types of Related-Party Transactions Reported by Companies

Fixed assets: Purchase	Income	Current assets (Receivable)
Fixed assets: Sale	Income: Consultancy	Current assets (Receivable) written back
Fixed assets: Transferred	Income: Services	Capital contribution
investment	Income: Shared Services	Capital withdrawn
Purchase of investment	Income: Sale of goods	Premium on equity contribution
Sales of investment:	Income: Sale of raw material	Corporate guarantee given
Provision for diminution in value investments	Income: Contract	Corporate guarantee taken
Foreign exchange fluctuation in investments	Income: Rent	Corporate guarantee redeemed
Investment written off	Income: Fuel, power, and	Corporate guarantee withdrawn

	electricity	
Investment in equity shares	Income: Royalty	Amount written off
Investment: redemption of investments	Income: Technical services	Equity shares received
Investment in preference shares	Income: Management fee	Tax collected at source
Debentures subscribed	Income: Dividend	Share Warrants: Received
Funds transferred	Income: Management services	Equity shares issued
Funds transferred: On behalf of others	Income: Interest	Investment: Share application money given
Funds transferred: On behalf of the company	Income: Other	Investment: Share application money refunded
Loans & advances: Not specified	Income: Commission	Income: Reimbursement of expenses
Loans & advances: Given		Redemption of shares
Loans & advances: Received	Income: Operations	Bad debts recovered
Loans & advances: Received back	Income: Unearned	Bad debts written off
Loans & advances: Repaid	Income: Share of profit Reversal of provision for doubtful debts	Provision for doubtful debts
Inter-corporate deposits (ICD)		ICD: Refunded
ICD: Given	Income from buyback of shares	Income: Sale of subsidiary company
ICD: Received	Payment: Shared services Payment: Managerial remuneration	Current liabilities (Payable) written back
ICD: Repaid	Payment: Services	Contribution to funds
ICD: Matured	Payment: Goods	Debenture repayment
Income	Payment: Raw material Payment: Fuel, energy, and power	Payment: Benefit plans
Income: Consultancy		Current assets (Receivable) Current assets (Receivable) written back
Income: Services	Payment: Rent	Capital contribution
Income: Shared services	Payment: Royalty	Capital withdrawn
Income: Sale of goods	Payment: Technical services	Premium on equity contribution
Income: Sale of raw material	Payment: Management fee	Corporate guarantee given
Income: Contract	Payment: Donation	Corporate guarantee taken
Income: Rent	Payment: Interest	
Income: Fuel, power, and electricity	Payment: Contract expenses	Corporate guarantee redeemed
Income: Royalty	Payment: Other admin expenses	Corporate guarantee withdrawn
Income: Technical services	Payment: Other	Amount written off
Income: Management fee	Payment: Dividend	Equity Shares Received
Income: Dividend	Payment: Operating expenses	Tax Collected At Source
Income: Management services	Payment: Commission	Share Warrants: received
Income: Interest	Payment: Insurance	Equity shares issued Investment: Share application money given
Income: Other	Payment: Intangible assets	
Income: Commission	Payment: Liquidated damages Expenses: Incurred on behalf of others Expenses: Incurred on behalf of the company	

Source: Data collected from annual reports

Appendix 3

Sample of disclosures

Illustration 1

(1) Related Parties

- a) Fellow Subsidiary: WE Ltd, WCP Ltd, GSE Ltd, W H Pvt Ltd
- b) Subsidiaries: WA Ltd, WG FZE Ltd, WR Ltd, WIL Ltd, B2B I P Ltd
- c) Joint Ventures: DI Pvt Ltd, WW Ltd, MPSEZ Ltd, WW Ltd
- d) Associates: WL Ltd, WE Ltd, LSS Ltd, WG Pte Ltd
- e) Holding Company: WS Ltd

(2) Disclosure in Respect of Material Related-Party Transactions during the Year

1. Sales (net of return) to: M/s. WE: INR 644.97 crore (previous year: INR 164.45 crore); WG FZE: INR 404.72 crore (previous year INR 466.31 crore); WG Pte Ltd: INR557.57 crore (previous year INR 623.76 crore); MPSEZ Ltd: INR 34.12 crore (previous year: INR 31.25 crore); WL Pvt. Ltd: INR 30.63 (previous year: Nil); GSE Ltd: INR27.33 crore (previous year: Nil); WW Ltd: INR 110.25 crore (previous year: INR 94.72 crore)
2. Purchase (net of return) from: MPSEZ: INR 83.94 crore (previous year: INR15.36 crore); WG Pte Ltd: INR 703.31 crore (previous year: INR 503.78 crore); WW Ltd: INR 26.99 crore (previous year: INR 1234.90 crore); WE Ltd: Nil (previous year: INR 202.80 crore); WW Ltd: INR 3.23 crore (previous year: INR 38.26 crore)
3. Sale of Investment to WW Pvt Ltd: Nil (previous year: INR 0.03 crore); MPSEZ Ltd: Nil (previous year INR 0.00 crore); B2B I P Ltd: INR0.05 crore (previous year: Nil)
4. Sale of Fixed Asset to: MPSEZ Ltd: Nil (previous year: INR 0.32 crore); WW Ltd: INR 2.45 crore (previous year: Nil)
5. Purchase of fixed assets from WW Ltd: INR 0.05 crore (previous year: Nil)
6. Purchase of investments from W H Pvt Ltd: INR 106.04 crore (previous year: INR 0.54 crore)

Note: Figures and names have been provided for illustrative purposes only.

Observation: Each of the parties is listed separately in (1) and the transactions are given party-wise in (2). In order to understand the total transactions with a related party (say a subsidiary), we have to refer to (1).

Illustration 2: Case of associates & JV combined together

Description	Associates and Joint Ventures		Key Management Personal		Enterprises Controlled by Key Management Personnel and Their Relatives	
	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year
Purchase of goods/services	12885	7541	-	-	2333	4647
Sales of goods(incl. capital goods)	25164	13027	-	-	95452	44677
Rendering of services	-	-	-	-	33	008
Investment in equity shares during the year	069	003	-	-	-	-
Advance against share application money	1806	5	-	-	-	-
Other advance given/(taken)	-	-	031	026	2773	-
Rent and other expenses paid	-	-	002	-	-	004
Interest received paid	011	007	-	-	293	2558
Dividend received paid	-	-	-	(017)	-	(1306)
Remuneration	-	-	8575	8218	-	-
Lease rent received	-	-	-	-	3	54

Note: Figures have been provided for illustrative purposes only.