

Session 1: The Role of the Board in Related Party Transactions

Opening remarks:

Mr. Tejendra Khanna, Executive Director, Ranbaxy Laboratories Ltd:

Just one or two minutes, basically, what I understand is, I am not from the business stream but I was told long years ago that if you want to succeed in a business, you buy cheap and sell dear and therefore you get a very good margin. If you want to fail in a business, you buy dear and sell cheap. In a way, what this is really saying is that when you are buying cheap and selling dear, you are creating incremental value into the business. There are net inflows of value into the business and when you are doing the reverse, buying dear and selling cheap, you are basically causing value erosion or value stripping from the business. Now since these companies are all constituted into distinct legal entities, there is a fiduciary responsibility on the directors and the people who are working in the company to ensure that for that legal entity, they are acting in a manner, which leads to maximum value accretion or value addition. This whole business of seeing whether it's proper corporate governance in particularly, whether related party transactions, result in negative value stripping or value erosion or not is in a sense part of the fiduciary responsibility cast on the board of directors.

I would say that in this room, all the members of the audience from the corporate community, if one were to say, is there any business in India where there are no related party transactions, I think, the answer would be a resounding 'No'. Every business does have related party transactions. Ranbaxy itself has close to over 50 global subsidiaries and 80% of our global turnover is through these subsidiaries. We manufacture products, which are sent to them. Sometimes we manufacture the active ingredient, they are sent for value addition in taking up to the formulation stage by the subsidiaries and then sold. There are all these related transactions taking place all the time and there are of course protocols for arms length pricing that what we sell to our subsidiaries will not be cheaper than what we sell to a third party, which is the fair value concept. When we say that we want to move into patterns of compliance with global standards in corporate governance and all of these other issues because now lots of Indian corporate really are beginning to emerge on the global stage, they are no longer limited to the Indian market place, Indian economic space, they are now regarding themselves as players in the global economic space. When you want to drive into or participate in the global economic space, you have to then comply with the global traffic rules and it is there when all of these standards begin to apply much more rigorously.

I think, all of us here, understand very well what is intended, when we say that related party transactions should be brought under scrutiny of the board of directors. Again, as was very correctly mentioned, the intention is not just a formal requirement that you place some documents before the board for routine

signatures, the actual purpose behind it, the underlining objective is to make sure that those transactions are not resulting in, what I call 'value stripping'. I think, that is a very key element, which has to be borne in mind. Professor McCahery very correctly said that, dealing with a related party is per se, not illegal or un-called for, you can have legitimate related parties who say yes. For instance, I will give you an example. It is a sister organization, the Fortis Healthcare Group. Fortis Healthcare group, we had in Ranbaxy, a diagnostic business called 'Specialty Ranbaxy', it is the country's best diagnostic services company. Sometime ago, we said, it is not a part of our core business of pharmaceuticals, manufacture and selling, so we hived off that business and Fortis invested in the equity and took it over. Now, Fortis as a part of its healthcare, indoor patient care, outdoor patient care is using the services of specialty Ranbaxy to test out various kinds of samples. By itself, there is no harm in doing so but the point would be, are we paying for those diagnostics, whether it is blood differential counts or it is testing in any other area. Are we paying them anything more than we would for a competing Path lab, that would be the relevant question and of course, sometimes, you may have a situation that Specialty Ranbaxy is carrying out a very sophisticated test for which you do not have a second offering in the country because now they are getting into basically cells histology and molecular biology in a very sophisticated way. I was told by a person who was looking for some cooperation with the Fortis Healthcare was working in the National Cancer Research Centre in Singapore. They now have equipment in which the first signs of cell metabolism irregularity, which can manifest, seven years down the road in something which is detectable through other means as evidence of some kind of cancer. The first couple of molecules in basically a population of several billion molecules can now be picked up and identify that there is something irregular, gives you an early warning system, something is going wrong with cell metabolism, whatever may be the provoking causes. What I am trying to say is that if in a particular outsourcing arrangement, you have placed business with a company where you do not really find a comparison or an opportunity to give a open kind of tender or enquiry, you might have to enter into that transaction wily-nily so per se, it is not wrong but what is now being mandated is that Board of Directors should very carefully apply their mind to see that in these related party transactions, is the company for which they are morally responsible to see that all transactions result in maximum accretion of value into the company or maximum or minimum outgo of funds or resources out of the company. Well, that is something they need to look into carefully.

One more example, I am a director on the Nestle Board. I find one of the co-directors, there are three Indian directors, three Swiss, one happens to be a senior partner in a Law firm. Now for last twenty-five years, he has been on the board and also he provides legal services in terms of both chamber advice and appearance in courts to the company and the question came, is he, by that virtue of the fact that he is providing these services, is he dis-qualified from holding office under certain provisions of the Company's Act. Now what he says is, from my point of view, what I am providing is basically anything what we would call

'best of class' comparable, competitive. Basically I am not saying to display that you have to give me that legal brief for the company, it is open to go to any other competing firm, it just happens, in the wisdom, they do give me some brief but I have never used my position on the board to lobby that certain additional brief should be given to me rather than to other firms and this is where he comes up with a very candid closure, there is no conflict of interest in my being a director on the Board and also my firm providing legal services. You do get into some borderline issues but the whole purpose of this kind of discussion is to see that we should now become aware that there is really, in terms of the global standards. Now if we all want to copy and I know that in the Indian context now, the whole mindset including our top level civil service advisors at the Government of India level, Ms. Komal Anand, my distinguished colleague from the service from which I am is here in the audience.

It is absolutely clear, India now sees itself as a global player. Ranbaxy for the last 15 years, 20 years, saw it as a global player and that is reason, why amongst all India Pharma companies, we are the ones, which have the most diversified global footprints today but when you see yourself as a global player, there is an obligation, you also then have to accept the responsibility for conforming to global best practice and global standards. You do not have a choice and I know that the whole of the corporate community represented in this hall, certainly has that kind of a commitment, that's why, possibly, they are here.

So, I will now close my comments on this, I think, this is a very relevant theme. In Ranbaxy, what we are doing is because we do deal with a lot of subsidiaries, we have outsourcing for inputs, we have selling arrangements for our product, we certainly ask Internal Audit to keep a very watchful Eagle's eye. Are they coming across anything which, would suggest that those transactions are not in the company's best interest. They do the first level scrutiny and then bring it to the board and as regards, what the board has done, we have basically gelatinated number of these transactions, the input side and the output side because they were not conforming to good corporate governance and good practice.

Distinguished Panelists and particularly Professor McCahery for this session and further without adieu, I would invite him to make his presentation and then we will have other panelists speak and then open the discussions to the audience.

Presentation:

Professor Joseph McCahery, Professor of Corporate Governance and Innovation, University of Amsterdam, Netherlands

Presentation:

Mr. Harish Narula, President Corporate, Lupin Limited:

Ms. Komal Anand, Secretary Ministry of Company Affairs, Shri Tejinder Khannaji, Professor Joseph, Mr. Nawshir Mirza.

Professor Joseph has given detailed presentation which covers all aspects on the topic which he chose. Infact, there are lots of 'Do's and Don'ts' also, how to really go about. 50 years back, India has stepped into an open economy. We have gone into reforms into 1991 and that was the process we are in. When in open economy, the only instrument available is to regulate or to bring in systems. We had faced scam, US has faced Enron and WorldCom, the most important aspect, what I feel personally is, when you are in open economy, US is very large, most mature but still they were in a shape where nobody could answer them, what happened to Enron.

In this, two things I feel is the accountability and investor's confidence. These two things are most important, how we really govern into our system or in corporate governance and then the trust. What is happening today is that the audit committee or the board of directors or in related transactions, how to really check and monitor, infact this is most essentially required that we bring in trust, within the board and make audit committee more away of their responsibility to the shareholders, to the investors, to the public at large. Infact, I also stress that the independent directors, they should be given a real detailed training, what really they need to exercise. What happen is, if a good job is done, you need to appreciate and you would like to appreciate. If a bad job is done, it needs to be punished but nothing should be in-between, it has to be done. Any Act, any law, for that matter, must be implemented, then only you get the results out. Recent SEBI clause 49. The fact is that the audit committee, which is part of the board of directors, they need to really see, what actually is happening, although traditionally, we in India are family-based. In various countries because of good corporate governance the investors are prepared to pay even premium, like in Germany they pay 13%, in Russia 38%. Corporate governance is so necessary if we want to go international, we want to create international presence and all these transactions which happens needs audit committee's attention. Infact, I would like to say like this, more of a training, more of a responsibility, more of a trust should be created and a detailed technical presentation, Professor Joseph has already made and I would like to rather that the questions and answers, if any specific thing you can ask.

Thank you.

Presentation:

Mr. Nawshir Mirza, Independent Director:

A German philosopher believed that all men were brothers. He wrote an excellent book on that and some of you might even have read this book by that very name and there must be something German about this because there is also an old German proverb which says, everything is connected to everything so everything is related to everything, so all parties are related. So if we went by this fundamental philosophical belief, that if a man sneezes in Beijing, there is a snow storm in Chicago. If we went by this fundamental philosophical belief, then indeed, what related party transactions do we focus upon in business.

Fortunately for us, there is somewhat sharper definition of related parties. There are different definitions in different places and I have attempted one last night on the flight from Bombay on what I think could be a definition of related parties because the programme here says that, that's one of the subjects that speakers are going to deal with and I have attempted the definition and I am sure, it is floored but nevertheless, I will tell you what my definition of related parties in a business situation is, is that the two entities would be related parties, if one is a position, does not necessarily have to exercise that position but is in a position to either directly or indirectly influence the business decisions of the other party so in that case, both parties are related to each other and if you look at accounting standards, the attempt to use this definition I have given into something more concrete, they use influence of control and the example Professor McCahery had in his presentation is exactly that situation where there was one man who controlled 60% of company A and 90% of company B, so control or influence, shared economic interest and to bring in the factor of indirect control, family relationships, business relationships, so if my partner in business has an interest in something, I am also indirectly connected with that because both of us have a shared economic interest. I may not have directly, an interest in his business but because we share an economic interest, I could indirectly be influenced by this emotional connection, as it were, between me and my business partner and indeed between me and my wife, my brother-in-law and all the other vast army of relatives that all of us, Indians always have.

Now, in the Indian context, if we look at related party transactions, as I said to you when I had the opportunity to speak to you a little earlier, I said, the company law has always dealt with this, somewhat more narrowly defined but if you look at Section 295 which prohibits loans to directors, it is not like in the US where you can give a loan but not for this or the other, absolutely a prohibition, 297 which essentially deals with transactions between a company on which a director sits and another private company or other business or relations that that director might be interested in, 299 which is wider, which deals with all companies where he might have an interest and there is of course the 2% condition there, 314 (1a) where a director appoints a relative into the company or a director's relative works in a company, so there are several provisions in the company, as it

presently exists, we will have to see, what happens in April, now as it presently exists that deal with related party transactions, even if those are a little narrowly defined.

The accounting world has accounting standard 18 so that has defined related party transactions much more widely than company law currently has defined them. You have the corporate governance requirements, which fortunately go by accounting standard 18, SEBI has not attempted and third definition of related parties, it has essentially gone by accounting standard 18's definition. Then again the tax rules define related parties, those of you who are familiar with section 44ab, tax audit requirement, there is a requirement to disclose transactions with certain parties that are mentioned in that particular report under section 44ab.

The CARO, the company auditor's report order, requires the auditor to comment on certain related party transactions, the reasonableness of those transactions, in his audit opinion, so there is again, another requirement. Much of the CARO is derived and based upon related parties, as defined, under the Companies Act. Then there are the transfer pricing rules, which deal only with relationships, cross-border relationships but again that deals with related parties between India and another country. Those of you who deal with customs and excise or cenvat, know there are the valuation rules where if there are excise or customs transactions with related parties, the assessing officer is required to go through certain procedures. Indeed all tax statutes give assessing officers powers, whether it is sales tax, octroi, all tax statutes give a sort of over-riding power to assessing officers to challenge the value of a transaction that they suspect, whether it is related party or not related party but certain tax statutes specifically deal with related part situations.

So there have been very many attempts to change and there was one more when the Narayan Murthy Committee was appointed and the Narayan Murthy report, if any of you have read it carefully, would realize that it was nothing but a collection of the NASDAQ, the New York Stock Exchange and the Sarbanes Oxley Act, so they took all of these, put them together and submitted the report called the Narayan Murthy committee report. Now, fortunately, in my opinion, SEBI did not adopt the Narayan Murthy Committee recommendations with respect to related parties. What Narayan Murthy recommended, stealing from NASDAQ was that the audit committee should approve related part transactions. Now, the audit committee is the only independent entity within an organization that exists or has been created to have an oversight of what management does and the minute you give the audit committee the responsibility of approving certain things, you will impair its objectivity because having approved a transaction, whether it is pre the transaction or post the transaction, having approved the transaction, the audit committee can no longer be objective vis-à-vis that particular transaction, so fortunately, SEBI realized the fallacy of this

particular recommendation and has not adopted it but the new clause 49 does require the audit committee to review related party transactions.

Now, that's what I am going to talk to you about as to what is intended but before I talk to you about that, I would also like to point out to you one somewhat unique situation that prevails in India, which I don't think, prevails in most other countries is thanks to the foreign exchange regulation act 1977, we have in India the unique situation of a large number of listed companies which are also the subsidiaries of overseas multinationals. In most other jurisdictions around the world, multinational companies have 100% owned subsidiaries. In India, we have this unique situation, as I said, subsidiaries of multinationals, which have 40%, 20% local shareholding and are listed.

Having given you a little perspective on the Indian context on which we are talking, I come now to the topic of this afternoon, the board of director's role in related party transactions. Now, if you any of you have read the OECD code which is in your folders, the OECD requires the board of directors, not the audit committee, the board of directors to review related party transactions, there is a big difference and I will come to that difference and why I think, that's important, but before that, the question really is, today what do boards do with reference to related party transactions that's under company law and the boards have been doing this for the last one hundred years, since Indian company law bough in this particular concept with reference to Section 301 register. Now strangely, the Company's act says, the section 311 register shall be tabled in a board meeting and this is literally what I have seen happen in the board meetings now I attend as a Director and I earlier attended as an auditor. It is placed there, it is passed around, all the directors sign it in the column marked 'signature of directors'. There is no discussion because the requirement is not to consider or to approve but merely to place the register, it is only very rarely that in a board meeting, someone actually asks, are these transactions done at an arm's length so is that how, the new clause 49 requirement that related party transactions shall be reported to the audit committee, shall be placed in the audit committee.

It would be taking a very narrow view of the audit committee's role and function in today's environment if all that happened was, as required under clause 49 is different types of transactions were presented there, the audit committee looked at it and said, next item on the agenda. Indeed, I think, the requirement on the audit committee now, which ought to have been on the board and as I said, I will tell you why but nevertheless is on the audit committee is greater, I think, merely looking at what's placed before them. I think, the first thing the audit committee needs to see or whoever looks at this is the process by which related parties are identified, not transaction and while standard related parties are easily identified and most directors submit a list of companies on whose board they sit, the definition of a related party, both under accounting standard 18 as well as even under the existing company's act is much much wider and very rarely, if at all, do directors submit to the company the list of all of those related parties. By father

preponderance, don't do it by design, for example, I don't know what business interests my brother has so I have a challenge, if somebody said, Nawshir, you are sitting on this board and you have not given a list of all the business interests your brother has, I don't know, what they are. Indeed, it is not done by design but that particular loophole gives a director an opportunity to conceal certain relationships that he would be embarrassed to disclose and indeed, it is an old device of just about everybody, who writes a novel, the other women, so a lot of time is spent in a novel where there is the husband and wife situation and there is the third woman, there are many Hindi movies made on this particular theme and so just as the husband endeavors to conceal this particular extra-marital liaison he has from his wife, similarly there is no reason, why directors have a challenge in concealing certain extra corporate relationships they have from their companies so the first challenge is the process by which related parties are identified.

The second, having done that, is the logistical challenge of capturing every transaction with related parties who have been declared as related and I know, in large companies, it is difficult to get them. Infact, there is a very old Company's Act decision, under the 1913 Act, where a director brought a tin of ghee from a company on whose board he sat and he did not disclose that he bought this tin of ghee from that company and under the 1913 Act, that resulted, it went up to the Bombay High Court, that resulted in him vacating office on the day he bought that tin of ghee, so infact the 1913 act was far more rigorous, the current Act does not result in such things befalling directors but indeed there is the challenge of capturing every related party transactions, every tin of ghee bought by a director or his brother or his daughter or his grandchildren or his parents and all the other relationships that a director has.

Fortunately, material and significant transactions is what the requirement today of accounting standard is so as I said, we have to look at the process for identifying related parties, the process for identifying related part transactions and thirdly, the process by which, then those transactions are consolidated or accumulated and reported up, in this case, to the audit committee or to the board, whatever the case may be. Having received these reports, the body, the committee or the board, in my opinion, is required to address the reasonableness of those particular transactions because I don't think, it is sufficient, as I said, a little bit earlier for it to look at those reports and then turn the page and indeed there are many transactions for which reasonableness is not a major issue but what would have happened if the Government of India had insisted on Coca Cola India selling a large percentage of its shareholding to the public. It would have become a listed company and what would then be the challenge that would face the outside directors on that board because Coca Cola India needs to buy the secret formula which goes into the Coca Cola product from Atlanta. No one knows, what that formula is except a few people in Atlanta. No one knows, what its real fair value is so there is only one vendor of this formula in the entire world, this particular ingredient. How would have the directors have assess the

reasonableness of the price paid for that particular ingredient. Presumably, it's the same price at which they sell it to every one of the 180 countries in which they make Coca Cola, presumably, I don't know. Would the Indian directors have been in a position to even secure from Atlanta a confirmation that yes, we sell this at the same price to everybody. What if they had not been able to secure such a confirmation, so you have one challenge a board could face.

Second, what happens if you only have one customer and it is not uncommon in the chemical industry where bi-products are sold, in fact, right from a pipeline into an adjoining manufacturing business, which could be a related business in which the primary chemical producer has a small stake and there is also another major owner of that business. There is only one customer for that, maybe the product is generally sold in the market, maybe it is not, the same in reverse as one customer. What happens when you have related party transactions where there are other vendors or customers but no business is done with them, at least it is possible to secure some market price data. What happens if business is done with other vendors and customers, it is much easier, you have market price data so you have these challenges, different situations that you are confronted with and I think, the question before the audit committee is, first, is the information it receives reliable so if the management tells them, there is no other supplier of this particular product, how does the audit committee or the outside directors get satisfaction that, that's true that there are indeed no other vendors of this particular product, this is the only vendor or maybe this is the only vendor for the quantity we buy or the quality we buy or the kind of cycle in which we buy, there are no other vendors, this is the only one we can buy from, members of the audit committee so this is the first challenge we face when we sit in an audit committee and we are given such information.

The second is, what is the fairness of the terms, the total terms on which the transaction is done, not merely the price, the consolidated terms, reducing credit period, all of the other factors down to one comparable numeral, it is not difficult but you need to assess them. The question is, why at all do business with a related party, if it is possible to do business with others, must we do business with this related party and suffer all the consequence of doing that, why not just cease business with the related party, surely the related party is able to carry on its business with other counter-parties, does it have to deal with us necessarily?

What is the extra diligence that management exercises when dealing with a related party. Does it put that particular transaction through some extra filters or is it handled exactly as any other transaction is and if the related party is the only vendor or customer, how is management handling that particular risk that if the tap is turned off, what happens to our company, does it close down. So you have got all of these things that confront you. Now assume, you are able to reach some satisfactory resolution to these challenges and you appoint the internal auditor to look at those processes, the process by which related parties are identified, by which related party transactions are captured and finally

accumulated for reporting to the committee. Internal auditor submits a report and says the process is not satisfactory. What do you, as the audit committee do then? Indeed, one of the things you would do is to say, you got to first set the process right, then you got to go back and look at, if the process was right in the last nine months, eleven months, whatever period, what would have been the outcome of that particular process and what revised information would we have received and if it is not possible to reach a satisfactory conclusion by this particular exercise and that is not unlikely, the audit committee would then conclude that they cannot reach a reasonable conclusion on related party transactions, that the data they have received is complete and that it is reliable and that particular information would move up to the board. What would the board do then?

The board, I am afraid, at present, we have no guidance on, what it would do. It is very unlikely that the board would want to disclose this publicly either in its annual report or to any regulators. I think, the board would say, we need to set things right and on a prayer, let's move on to the next item on the agenda. That's what would happen. What would happen, if you ascertain that, yes, there have been transactions but these are not at fair value? Would there be an accounting response to that? Would accountants in the company or would the auditors say, book the transaction at fair value and book the difference between the fair value of the transaction and whatever value you have used for your transaction purposes as a capital account transaction, either as a payment of dividend or as a receipt of a benefit, which is not a normal business benefit. Would they? I don't think, today either the law or accounting standards permit us to substitute a fair value for the transaction value but indeed, I think, it is the responsibility of the board and the audit committed to make sure that the MDNA, the management discussion and analysis of the financial statements, that the MDNA brings out the fact that the company's profits would have been more or would have been less, had certain related party transactions been done at fair value and the effect is so many million rupees or whatever. I think, that is the appropriate response where you are aware of the difference between fair value and the value at which the transaction is done.

What if, the controlling shareholders and management thwarted such a disclosure. What do the outside directives do? Indeed, they have the power to dissent and to insist on their dissent being minuted and depending on the significance of the matter, maybe they may want their dissent to be minuted, it is for each director to determine or each group of directors in every company to determine, how they would respond to such a situation but indeed they should ask for their dissent to be minuted, if it is of a significance, that they think, merits disclosure and whether there would be a need for them to report to the regulator, if something, I would leave to the Lawyers to respond to.

I will just deal with a few issues before I sit down, which we need to address. The first issue is of non executive directors who are not independent and very

often are transactions where it is the relationship of the non executive director that results in a transaction being a related party but remember that in the law and there is an old judgment of that great jurist, Lord Denning, in the law, Lord Denning had said in his judgment that when you come into the boardroom, you have only one interest at heart, the interest of the company, the interest you represent, no longer prevails, outside of the boardroom, it may influence your behavior, in the board room, your interest is only of the company, not of the people who sent you into that room or not of the interests that put you into that room. So the non executive directors ought to behave in that fashion. Reality could be different. The independent directors, are indeed not supposed to have any related party transactions, I think, if there are transactions where the independent directors could be resulting in a relationship in a party, I think, that would straightaway impair their independence, they would no longer remain as independent directors but we have this situation even today of lawyers, accountants, who sit on boards, their firms render advise, sometimes they themselves are involved in that particular advise to the company, going forward, that is going to be a challenge. It was okay till now. The new clause 49 as well as Jamshed Irani's report, I think, we are going to see some challenges to that. Indeed, if I saw related party transactions arising from a relationship with management, my big concern would be, like Enron, are these transactions being done to smoothen the numbers. Maybe, they are being done to steal money, that's another issue altogether but are they also being done to smoothen the profit numbers or the financial results and they will reverse sometime into the future. Indeed, Professor McCahery referred to this, the code of conduct, the whistle blower policy, if there is a right culture in the organisation are important for unearthing transactions or relationships that were not visible earlier.

I said, I will tell you, why I think, the audit committee and the board of director's involvement is an issue. I think, the audit committee should not be involved because as I said, it could impair their objectivity. If they were involved in approving transactions, in my opinion, this sort of thing should go up to the board because if it is done at the audit committee level, indeed the directors who are actually part of that whole relationship in a related party are absolved because they are not involved at all with the approval of those transactions. It is they who should be involved with the approval of the transactions so that later if something is wrong, they can be held responsible. In the current situation the risk in fact is, they would survive, we did the transaction, it was for the audit committee to identify something was wrong and to point it out. We were not supposed to be asked this question, it was visible. We are related parties and a transaction has been done so indeed, the people who are responsible should be responsible for their approval so that they would be as much as in the dock as anyone else who is involved with that transaction and whether they should approve or review it, that's an issue.

What happens to non monetary transactions. That's a bigger challenge, where there are barter deals. Two companies, one supplying raw material to one and

buying back finished product from the other, not an uncommon situation, where a processing done but it is done as a barter transaction, sometimes without clear values being placed on them. Sharing common administration and management services, not uncommon in group companies. Are those being allocated at cost. Who knows, because the group company could be an unlisted company that provides these services and the listed companies are billed every month for services from that unlisted company. How do the directors on the listed companies know whether they have received a fair charge for the services they are being billed for. Artificial transactions. Quiet common. Sale and lease back. Companies want to move up their profits, move down their profits. Somewhere at the year end, the company does a sale of its office premises and lease back. With whom. A related party, which has party related the management which has been able to get a loan from HDFC or someone to finance such a transaction so transactions such as these which smack of two problems, one is that it is an improper transaction, worse that it is done as a device to manipulate the profit numbers and finally the difficulty of arriving at fair value and as some of you, who are familiar with the valuation rules in the tax statutes, there are essentially three or four stages that are involved in arriving at fair value and I don't intend to take you through those stages.

So in conclusion, I think, some of the things that perhaps we need to look at is, one is a consistent definition of what's a related party. Today, we have the Company's Act definition, we have the Accounting Standard 18 definition, we have the 44 ab definition, we have the transfer pricing definition, we have the definition under the excise and customs rules so there are different definitions of what are related parties. We could work with one standard definition of what a related party is.

Second, the Board of Directors and not the audit committee should be the body to which these kinds of transactions are taken. The audit committee should never be put into a situation where its objectivity is impaired. Third, the board of directors should be required, if there is a transfer pricing report to consider that report or if there have been challenges to valuation in customs, excise, sales tax, whatever to be made aware of those challenges and then to ask management to satisfy the board that those transactions were fairly valued at arm's length because these are the sources of information to the board for concealed related party transactions. Indeed the involvement of internal audit, Professor McCahery referred to the involvement of internal audit and being an instrument for revealing related party transactions as well as for evaluating the processes and lastly, in the inaugural session, Mr. Michael Carter from the World Bank referred to this liability for self-dealing where he said, India got only four out of ten, which somewhat surprised me because I am not sure, other jurisdictions necessarily have a more rigorous liability for self-dealing. Indeed, as I said, the old 1913 Act made you vacate office, if there was a related party transactions, which you, as a director was responsible for and you failed to reveal it, even if it was only a tin of ghee but the current law is not as rigorous but nevertheless, even under the

current law, the board has the power to abrogate that transaction. It could leave the related party hanging in the air because there are two sides to the deal but it has the power to abrogate that transaction and there are general penalties, even today under the Companies act for related party transactions that are not appropriately approved.

Questions & Answers

As a routine practice, 297, 299, 301, we go to the board for various interests of the director's disclosure, even in the starting of the financial year. Once having done that, don't you personally feel that audit committee is a better policeman than the full board for critical analysis of any related party transactions, if at all, it is felt by audit committee that it is against the interest of the company. This is number one.

Number two, I recommend that methodology or I feel that methodology is better because as it is, all the observations of audit committee are invariably as a routine practice, the recommendations go to the board for noting so therefore, if we adopt this methodology that any related party transactions goes to audit committee for evaluation first and then audit committee's recommendation as it is going to the board as a second tier will probably indeed scrutinise that particular transaction otherwise in the board meeting, this gentleman who is connected with the concerned part transaction will have a possibility of making the whole board biased. This is my view, please give your input.

Response:

I think, I was not clear enough. What I said is, the audit committee should not, never mind related party, any transaction or any management role, it should not approve, it has an oversight role so what you are saying, I am in entire agreement but if approval is required, then it should go to the board, not to the audit committee. I entirely agree with you that being independent, they are infact better at policing this, they do not have this group of connected directors to sort of thwart the full conservation on the topic.

Question:

My name is M. K. Chauhan from Asian Centre for Corporate Governance. As Professor McCahery said that related party transactions per se is no problem. We have no issues but the moot point which Nawshir also drove down so strongly is the materiality and the significant related party transactions. Now you also said that audit committee should not approve this and it should go to the board. Now what is significant and what is material because one of the slides of Professor McCahery, I saw 5% so some of the FII's because in the next session, I am going to speak, some of the FII's expectations from the Indian boards and Indian companies is that, certain transactions beyond a particular size should be ideally pre-approved in the annual general meeting and where from voting the majority shareholders should be disfranchised. Now this could be a little ticklish issue or whether there is a practicality in it, both views will be more than welcome.

Question:

My name is Neil Cooper. I am a partner amongst other things. A couple of observations. The first is, I find it very very surprising. You are prepared to contemplate having lawyers or accountants on the board with their company's

supplies goods to those companies and the reason I say that, this is not a company that is devoid of talent. There is quiet enough talent in this country. What you have got to be aware of is the section is truth and however independent these people may be in substance, it is the perception that they are not independent, that becomes the truth and which erodes confidence in the financial community so independents must not only be infact, it must be perceived to be infact.

Secondly, as things like Enron are concerned, I am delighted, we are talking about those, They have made my firm very very rich because we have spent the last two years reorganizing them and will come in a few others but that isn't really, what we should be talking about. These are frauds and we should be concentrating on the upside of corporate governance, those things that we should be looking for, the management of companies to do that is positive, the deciding value that is making their corporations more socially responsible. It isn't just about stopping fraud and I hope that emphasis of this conference is going to be on the upside.

The significance of connected parties is actually in this that where there are losses, you should find that the onus of truth that the transactions were bonafide is reversed. There is nothing wrong with connected party transactions, they happen in enormous values in groups of companies all over the world. Connected party transactions are quiet valid but if there is loss then it is up to the connected party to actually prove that those transactions were bonafide as opposed to the other way around.

Question:

I am Sumant Batra, Lawyer by profession. Just wanted to make a comment on Mr. Mirza's observation about Section 301 and the practice that prevails with regard to the placing of the register of related party transactions before the board and I do agree with you, though the practice is, it is tabled merely for the sake of information but neither is that the intent of the law and orders that the spirit of that provision and the section was introduced and as were the Parliamentary debates demonstrated with the intent to make it necessary for the board to deliberate, discuss and also approve, that is the intent of that law, although it is a different matter that in practice, it is not observed.

Question:

Considering the plethora of definitions which exist in this country as to related party transactions, what is needed perhaps for the corporate implementation of these related party transactions and its placement before the shareholders or before the board, I think, is a comprehensive way in which the related party transactions should be disclosed. There is no single way in which the disclosure has been specified. Every law, whether it be SEBI or whether it be Company's Act or whether it be any other law in force in the country, we do not have a single way in which it can be placed before the board. One of my learned colleagues

stated, we are placing the interest of the directors before the board, these are just duly noted and just passed on. What we need is a comprehensive way in which each director has a related party, what are the material disclosures he has to offer, those things should be specified. I need your opinion on that.

Question:

My name is Aman Ganguly. I like to ask the panel its opinion about this concept of 'arm's length' because apart from the individual situations where there are related parties, companies actually set up related companies to get some benefit, the whole idea of setting up a subsidiary is that it is going to benefit your operation in some way and then whether it is the law or whether it is principles of corporate governance, they all state that all transactions should be at fair value or 'arm's length' or whatever. Now it applies in the situation that Mr. Khanna mentioned, I am director of a company which has about 50 subsidiaries, mostly abroad and those subsidiaries generate most of the income of that company and of course, this is quiet common nowadays in India that you have subsidiaries abroad which generate your income, so would you like to make some comments on this whole concept of 'fair value' and 'arm's length' value of transactions between companies which are actually set up in order that the original owners, who ever they are, including the public should get some value out of them.

Question:

My name is S. B. Mathur. I am consulting Advocate in corporate laws. When we appoint a committee which is named as audit committee, the word 'audit' hits the mind first and when we say that audit committee will review a transaction, does it mean that it will only go over its contents or will it also go over its effects on the company's profitability and unit's report, will it specific to the board, what has been the impact of that transaction on the profitability of the company.

The second stage, when the board notes the report to the committee, will it also make it available to the auditors who are responsible to report about the fairness of the accounting and fairness of transactions in the company and will they say that a transaction has been responsible for causing financial loss to the company though it is a related transaction. Will they report to the shareholders. If not, what is the whole purpose of doing this exercise.

Question:

I am from the OECD. I just wanted to point to the document which you all have in your binder because indeed some of the speakers already referred to it in this document which is called the OECD principles of corporate governance which is applicable to listed companies, in particular. Indeed, there is some wording on related party transactions which can be useful and the reason I am underlining this is that this kind of definition used herein is being adopted or recognized throughout at least the 30 OECD countries and like Mr. Chairman said, India is entering the world stage and indeed global standards such as this one could be used as a reference source. In addition, there is also sure definition of what

material information can mean. Maybe that could be useful for institutional investors as well. Indeed, again, it's a definition of materiality which is recognized by the OECD countries. I just wanted to add this.

Response:

Professor Joseph McCahery

On the first question and in terms of thresholds, I think, most of the listing rules will define what the thresholds are for you so that does lot of the work and boards will have to satisfy that, every time they hit that threshold either above or below it depending upon what the threshold is, 3 or 5% increasing. On materiality, OECD standard has been accepted by many countries, other jurisdictions define, what materiality is for themselves.

We turn to the second question. I agree with the sentiment about lawyers being on the board probably shouldn't be providing services. In the United States, in the seventies and eighties, we had lawyers and financial intermediaries serving on boards where they conflicted position. Best practice now in the US and UK is that, there are no service providers on the board, no matter what the relationship is, indirectly or directly and I agree that they may not have any so-called direct involvement. It is just the perception of leading practice so that I think, that practice has stopped at least in the United States.

Upside of corporate governance. I think, that is a rosy picture. I would disagree that related party transactions are constant issue with corporate governance so I think, we should have this upside because corporate governance is all about value, I agree. 75% of corporate governance is downside protection and it is 25%, yes, we should specialize. I put on some statistics that try to show today that the upside is actually regulating related party transactions in a cost effective manner, that is the upside so we have to talk about the downside and then look for the benefits that come from fair regulation that is effective so it is hard to ignore that, at least the amount of value destruction that we saw in a number of economies for certain number of years, can't be addressed by measures that will, in the long run, produce guides, so I agree with the sentiment. Let's specialize on the 25%, let's not look at the 75%, deadly cost that goes to corporate governance. In terms of connected party transactions, I think, that has been raised twice in the comments, so there is nothing wrong with connected party transactions, infact, we should encourage them, particularly in jurisdictions like Germany and others, India which have group of companies and we have fairly well and clear standards about what the fiduciary duties are in groups. It doesn't create much of a problem unless there is a difficult with enforcing the fiduciary duties.

The Delaware standard is exactly the one that was offered here, which is that, the party that may infact be presumptively involved in material transactions that causes a conflict has the presumption or the burden to show that he or she is not involved in that transaction so that infact is Delaware standards, that is good law

for thirty years. It is also good on the UK so this is infact a standard, we are very happy with, even if a board doesn't approve a transaction, presumptively then, if it is a loss preceding, the party just has to show that the difference in value was such that they didn't profit from it, if that can't be shown, then it's a fair value determination, that's the global standard, I don't think, we have much problem determining that so I was offering that as a simple way to go forward and whether we want to do that or not, most large corporations are pretty familiar with that. The question is, who we are going to have provide the fair value determination. I think, that's a political issue and I wouldn't want to get involved, the Germans have a very different view from English and American about what methodology for determining fair value, how long it takes to determine that and whether the court should be involved in making that jurisdiction directly or let some specialists do it indirectly. I am more for using standard techniques and getting the right value though those techniques. Delaware law doesn't have a standard for using modern financial technology, it used to use historical valuation. I don't think, Delaware necessarily is the way forward, we just had in practice use modern financial technology for it so jurisdictions have a choice.

Just finishing up on the question about subsidiary support. You could decide that perhaps these transactions are so valuable that you want to suspend related party transactions legislation but I don't think, that would be the way forward. I think, real question is, jurisdictions where most of those transactions take place, either it is a commonwealth jurisdiction where infact, we have quiet a bit of regulation and don't worry too much about it. From this statistics, we saw that wouldn't create a problem. If it is Germany or other jurisdictions, which have lesser transparency and not an effective means, then I think, we want to be more agile and more concerned about it but overall the policy recommendations, I think, are more local.

Response:

Mr. Nawshir Mirza:

I think, the first point what is material has been, to an extent, dealt by Profession McCahery a little earlier and as he rightly said, maybe you need to take an accountant's perspective on what is material. What is material is anything that would make you change your opinion if that difference was infact captured, whether in transactions or in the financial statements, whatever. If it wouldn't make you change your opinion, it is not material so if it would result in investors in a company, taking a different decision as to whether they should continue to hold the stock or to sell it or investors into the company deciding as to whether they ought to buy it or not buy it, indeed that would be material, that is an accountant's definition and accountant's use is certain bench-mark numbers for that but every firm has its own rules so I will not be able to tell you what numbers these people use. As for this concern and I am myself concerned about this. Even the JJ Irani committed has recommended and to use your phrase, Mr. Chavan that interested shareholders should be dis enfranchised when at the

general meeting, a resolution in which they are interested is put up for discussion.

Now this is a little like, if you sit on the House of Lords, you cannot vote in the elections to Parliament, I think, that is the rule in England so it is perhaps a little like that. I am not at all in agreement with this because indeed when you buy stock in a joint stock company, it is a joint stock company, you are aware that there will be a controlling shareholder and the controlling shareholder exists in order to protect his own interest too in that company and if every transaction was left to the whim of all the other shareholders where he couldn't participate, I think, that would not be corporate democracy on the contrary. So I am not in agreement with that. I am in agreement that there should be full disclosure of what is the transaction, what are the consequences of that transaction, all of that should be fully disclosed but it would be most iniquitous if somebody holding 80% of capital in a company couldn't have a say and 10,000 others who hold the 20% would be able to determine as to what major transaction that company does. So I am in complete agreement and I was astonished that the Jamshed Irani committee recommending such a solution, so I certainly hope that when they write the company law, which we are going to see shortly, we are not going to see this incorporated into that.

I agree with Mr. Batra that the intent of the 301 register was never to do that. What I infact was saying is that, even the new clause 49 is somewhat similarly worded as the 301 register and it would be a fallacy for audit committees or boards to therefore treat it in similar cavalier fashion. It is placed before us, now turn the page because that's what we do with the 301 register so I entirely agree with you and so I infact went through and said, what more you would expect the audit committee to do.

There was a gentleman who did not tell us his name, at the back, who said there is no format mandated for disclosure. Indeed Sir, accounting standard 18 now, which applies only to large listed companies, I must admit, does prescribe a format and it's a fairly informative format. Indeed, it could be made much more informative but then the annual financial report would need to be a far thicker document and we also heard both in the inaugural as well as in the session today, this morning that brevity is also important if people are to become participative shareholders and if you have an annual report that runs into maybe thousands pages because it lists actually the details of transactions, that would be a little embarrassing. Infact, if you see some of the prospectuses, there is such a requirement and in prospectuses, they do put in a lot of detail on related party transactions. I always wonder, who ever reads that, except competitors to the business.

Mr. Aman Gangulay's question, Sir was addressed to you, so I will pass it.

Another question was, does the audit committee review only the content of related party transactions or do they also review the effect on the profit of the business. Indeed, if the related party transactions was not at fair value or was not at arm's length value then the audit committee and the Board of Directors, should be concerned as to therefore, what is the effect on profits. Yes, but as everyone has said today, 99.99% of related party transactions are at fair value but indeed, I agree with you, it is this .01% which in quantitative terms may be small but in value effect could be large. If it has an effect on profits, indeed that should be the responsibility of the audit committee to report up to the board. Yes, I agree with that. I somewhat dealt with that in what I said to all of you and how would the auditor respond. Having retired from the audit profession, some years ago, what I tell you could well be completely obsolete so please do not take this as gospel. But the auditor's response would be, one is the Caro report, he is required to comment on certain types of related party transactions, fairness of those and indeed there he would be required to disclose that, these were not done at fair value and this is the financial effect of that activity and since the Caro report is a part of his total audit opinion, anyone reading the Caro report could use that number to work out, what is the profit effect.

Response:

Mr. Harish Narula:

Infact these subsidiaries are created to support flagship companies, this is historical practice and these in related transactions are also taking place. The fairness, we have brought laws and the Board of Directors and Audit Committees but I would still like to reinforce the point that we need to educate now at least, when the economies have opened up and we are looking for globalised competition and going beyond boundaries that role of audit committee and Board of Directors to be more responsible, accountable and creating value for the shareholder for the investor and this is in the interest of the organizations that if good governance is well practices and transparency is displayed, infact, they create more wealth than the losses.

Mr Tejendra Khanna

So in closing, just one or two observations.

I happened to be on the Board of two Tata Group companies and it has been my personal experience also. Tata AIG General Insurance, they didn't get business from TISCO and they didn't place business with Tata Infocomm and information related services and the question was asked by a director of Tata Sons, on the board, how come this business you could not secure from one of the group companies. Plain answer was, we could not compete with the terms, which was offered by the competition in the industry and this is regarded definitely within the Tata group as a very adequate and complete explanation of why business was not placed with a group company.

There are 69 companies in the group but I am very happy to tell you certainly, my observation that they have rigorous corporate governance and independently taking all of these decisions in terms of individual corporate entity.

Second point about the subsidiaries and how we evaluate the reasonableness of transactions which are entered into with our subsidiaries. I think, number one, tax authorities sitting in those host country jurisdictions where subsidiaries function, they are very keen to make sure that the subsidiary has not paid more than it need to have paid for certain inputs or services, it secured from overseas than what would be normally expected to be paid for similar inputs. At the same time, they also want to make sure that in selling their final outputs, they have not again transferred in a kind of manipulative way, value to some other entity in order to evade tax liabilities, so one is their own scrutiny. Second of course, is we have our own accounting standards to see that there is fair value and arm's length and all our companies, we have infact specific external auditors who will go into, I think, Mr. Aman Ganguly, when he was chairing PWC, if I recall, because I am on the Nestle Board, they had audited the adequacy and robustness of transfer pricing vis-à-vis Nestlé's dealing with Nestle International and its group companies so whether it was selling our final processed coffee and filter coffee and all those things and they give certificates, every transaction has met the test of independent audit scrutiny.

So I think, one another practice, which I found in Nestle, which is worth sharing with our distinguished audience here, all their purchasing is now moving to Internet base, electronic trading so since wide open, anybody, when certain purchases are taking place and they put a price, it is basically internet auction. You have to go by the best offer, which is there on the table and that make sure that you are not entering into clandestine transactions which will transfer illegitimately incremental value to somebody else, who happens to be a supplier.

I think, we have had a very useful two hour session.

The point with which I would like to close, I think, our distinguished panelists made excellent presentations, they were very comprehensive, extremely well grounded in the Indian experience in terms of what Mr. Nawshir Mirza said and Mr. Harish Narula said but I think, time has come really for leaders of the Indian corporate community and all of you sitting here represent that segment too now, as I said, become more conscious that, this is an issue which needs to be dealt with very seriously and very professionally and if such transactions are taking place, they need to be brought outside the wood work and subjected to very carefully professional scrutiny and if indeed, it is found that there are some things, which take away real value from a business then I think, we need to change our ground rules and begin to see that these things are not allowed to be persisted with.

So with that thought, I would like to very warmly thank my distinguished panelists and all the members of the audience for their active participation and their very patient listening.

Thank you.