FAQs on Purpose and Effect test for RPTs

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Meaning of purpose and effect (P&E)

Substance over form approach

1. **The purpose and effect seems to be intended to apply the substance over form approach to identifying RPTs - that is, if a transaction is substantively an RPT, merely because of the technical construct and interposition of parties, it should not be possible to avoid it as an RPT. Does this also imply that companies should take a "substance over form" approach to identifying "related parties"? That is, wherever there is ingenious structuring of relationships to fall out the exhaustive definition of "related party", should the scope of the term "related party" also be extended?**

   Truly speaking, RPT controls and disclosures are intended to prevent conflicts of interest affecting the working of companies. Given this intent, the approach to RPTs must always be based on substance rather than form.

   IndAS 24, para 10, clearly provides: "In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form." The substantive, rather than formal, approach may be used both to escape a relationship from the purview of "related party" as also to include such relationships.

   However, the regulatory definition is mostly based on thresholds of interests. For example, an entity is a part of Promoter Group ('PG'), in case of a promoter being an individual, based on a 20% shareholding. The aggregation of holdings is also based on precise rules. More subjective definition such as "acting in concert" is missing in the case of the promoter being an individual. Holdings through trusts are apparently not covered. Further, the definition of PG does not seem to refer to indirect holdings. Thus, it may be possible, as is quite common, for individuals to have a network of entities having cross-holdings, and then retain control with the individual having less than 20% holding.

   In such cases, are we meaning to traverse beyond the meaning of "related parties" given in the regulations, and rope in such parties as are known to be promoter entities but do not fall in the technical cast of the definition?

   The purpose and effect test expands the definition of "related party transactions", and not "related parties". Therefore, it may be possible to contend that the amended regulation did not intend to go beyond the definition of "related party". The purpose and effect of the transaction in question has to benefit a related party, which is to be read as per the existing definition.

   Per contra, it is possible to contend that if transactions have been done with parties which, by contrived or engineered shareholding, are falling outside the definition of "related party", and the purpose of doing the transaction with such contrived party was to benefit the related party sitting behind the facade of the contrived relationship, one may still apply the purpose and effect test.

Devising ownership structure of really related entities, such that the entities fall outside the definition of "related party", is just another reflection of the same urge to create subterfuges and smoke-screens for transacting with related parties. If the regulation was to attack "structured transactions", but was to turn a blind eye to "structured entities", the very purpose of the regulation will be defeated.

The twin tests of purpose and effect are intended to rope in transactions which wouldn't have existed but for the relationship. That is, ordinary commercial prudence would not see such transactions. In such cases, if there is a benefit flowing to an eventual related party behind the network of holding entities, it should fall within the purpose and effect test. If the structuring of transactions through networked entities avoids the entities falling within the definition of "related party", the transactions also escape the audit committee, and where needed, the approval of shareholders. It is notable that the approval of material RPTs requires the approval of a majority of minority (MOM approval) in most countries currently. MOM approvals, in the age of information symmetry and proxy advisers, have increasingly become difficult. That process of approval may easily be escaped, not just by structuring transactions, but also by structuring entities.

Therefore, if, behind the maze of entities that fall outside the definition of "related parties", the real beneficiaries are related parties, the purpose and effect may still be deployed.

Twin tests of P&E

2. What do we need to see to apply the P&E test? Purpose, effect, or both purpose and effect?

The language used is "the purpose **and** effect of which is to benefit a related party of the listed entity or any of its subsidiaries". Quite clearly, we have to see the purpose as well as the effect.

3. What does "effect" mean? Collateral, tangent, indirect, partial or eventual effect, or does it mean clear, direct, predominant, and immediate effect?

Since we are talking about transactions structured with the intent of benefiting a related party, the effect, that is, benefiting a Related Party (RP) should be immediate, direct, clear, and predominant. Incidental, oblique or partial benefits to an RP should not matter. That, however, does not mean one can get away from the definition by bringing multiple layers or networks of entities.

If the RP is one of the beneficiaries, along with several unrelated entities, and the transaction is done in ordinary course with ordinary commercial wisdom, it usually would not be the case that the dominant intent of the transaction was to benefit a related party.

4. It may be possible to establish the "effect" of a transaction - for example, a tangible benefit may have flown to a related party. However, how does one establish the purpose?

The purpose of every genuine transaction done by a company is commercial - that is, the transaction is done for the company's wider interest. That is where the question of commercial propriety comes in. Where transactions are done with the purpose and effect of benefiting a related party, we deviate from commercial expediency and do a transaction with the clear motive of tunneling a benefit away.

Truly, looking at a transaction, its purpose is never visible. If the transaction was done with the purpose of benefiting a related party, the transaction would show some or the other indicators, such as:

- It is a transaction that is not ordinarily done by the entity - for example a guarantee, loan or investment, other than for a subsidiary or associate, or a lease or a property purchase or sale transaction, or an advance of a substantial amount.
- The apparent commercial expediency of the transaction is not visible.
- The transaction is typically sanctioned at a central level and not by the usual decision-making hierarchy. For example, the transaction is sanctioned by the CEO, a director, or the promoter.
- Transactions which are long standing in the books and remains unconcluded like long standing advance, trade receivables, advances of capital nature, etc., and likewise, funded or unfunded support such as guarantees, leases, take or pay contracts, upstreaming or downstreaming of profits such as royalties, brand usage fees, etc.

5. We say that a P&E transaction is one that lacks commercial wisdom, and is done solely or primarily to benefit a related party. If that be so, is it possible to contend that, if a transaction is clearly providing a benefit to the entity, it cannot be a P&E transaction?

No, such an interpretation is not entirely correct. An RPT requires disclosures and control, no matter how beneficial or how sacrosanct the transaction may be. Therefore, transactions being arms' length as well as in ordinary course of business also go through RPT controls and are disclosed, under listing regulations and under accounting standards.

However, if there is a related party, who is using a camouflage and is therefore, trying to avoid the transaction being treated as an RPT, that indicates a clear intent to escape the radar of controls and disclosures. If the transaction is above board, there is no reason for the transaction to be structured as a disguised RPT.

That having been said, transactions which can be established as in ordinary course of business and arms' length have less apparent reasons to use a camouflage - therefore, there is less reason to raise any red flag in case of such transactions. Since the P&E approach will eventually have to be focused on red flags, the red flags don't need to go up in such cases.

6. If a transaction is done with the sole or primary intent of benefiting a related party, and such related party has deliberately concealed the transaction, is it not a case of a fraudulent transaction?

The necessary elements to establish a fraud are intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person. A fraud is deliberate, and is a conscious design to hide facts, provide wrong facts, etc.

RPTs themselves are not fraudulent, but if there is a deliberate attempt to disguise what is clearly a related party transaction, and therefore, seek unscrupulous benefit and avoid independent scrutiny by the audit committee, it may be contended to be a fraudulent transaction.

Not every undisclosed RPT is a fraud, but it is quite possible for an undisclosed RPT to meet the elements of fraud against minority shareholders and the company.

7. **We have a transaction, where it is possible to say that there is some benefit accruing to the company, and some benefit accruing to a related party. Can such a transaction be brought under the P&E test?**

   Using the same analogy as has been used in case of tax anti-avoidance rules, where the same expression "purpose or effect" has been used, one should apply the P&E test where the sole or dominant intent is to benefit a related party, or where the benefit to a related party was not merely incidental.

8. **To see the effect of a transaction, i.e., whether it is benefiting a related party, do we have to see the immediate counterparty to the transaction, or do we see the layers of counterparties?**

   The whole approach is anti-avoidance; hence, one cannot be looking at just the party with which the entity is transacting. That is, it should not be possible to avoid the regulation by interposing more than one party.

   However, since we are talking about both the purpose and effect, in case of transactions with multiple stopovers, usually, there should be an immediate nexus between the transaction and the benefit to the related party.

Applicability

9. **Is it applicable for reporting done after April 1, 2023 or for transactions after April 1, 2023?**

   This is applicable for transactions undertaken after April 1, 2023 either under an existing contract or as a fresh transaction.

10. **If there is a continuing transaction, should the same be subjected to the purpose and effect test from 1st April 2023?**

    If the transaction is a transaction during FY 23-24, it should certainly be considered as a related party transaction. If it is a fixed term contract, there may be contention that the contract has already been done, and the question of now approving or reviewing the contract should not arise.
    However, since the contract in question was not treated as an RPT originally, it obviously escaped the regulatory controls. Therefore, we suggest that even existing contracts should be brought before the audit committee.

11. **Whether the P&E test is to be applied w.r.t. RPs of listed entity only or even for RPs of subsidiaries?**

    The definition of RPT has been widened to include transactions between the listed entity or its subsidiary on one hand and the RPs of the listed entity or any of its subsidiaries on the other hand. Similarly, the ambit of P&E test is also extended to transactions undertaken to benefit the RP of the listed entity or any of its subsidiaries.

12. In FY 23-24 or any year thereafter, we find transactions that were engineered with the P&E of benefiting RPs. What do we do?

Ordinarily, not having or not finding transactions which are maligned with P&E is expected. If deviations from P&E are found, it has several serious repercussions:

(a) It indicates lack of internal control.
(b) It may indicate deliberate wrongdoing on the part of those responsible for such transactions.
(c) It may result into financial statements not reflecting a true and fair view.
(d) It may reflect on the quality of audit, etc.

Therefore, at any stage, irrespective of whether transactions with maligned P&E are found, they are a matter of serious exception. The fact that the transaction does not relate to the current year does not matter.

Examples of P&E test

13. A bank gave a loan to an unrelated party. The unrelated party buys insurance from an insurance company which belongs to the same group as the bank. Can the P&E test be applied here?

At the very first instance, the purpose of giving a loan to a borrower is not to enable the borrower to buy an insurance from the related insurance company. Therefore, this transaction certainly doesn't get hit by the P&E test.

However, there may exist a corporate agency between the lending bank/ nbfc and the insurance company, which itself is a related party transaction. There are various regulations on corporate agents, whereby agents are required to give wider choice to the insured. But if the bank is tying (force selling) the loan with an insurance cover from a related party, this may indeed be an issue in terms of corporate agency regulations of IRDA, not so much from the point of view of RPTs.

14. A bank gave a loan to an unrelated party. The unrelated party uses this loan to settle an outstanding and stressed loan exposure from an NBFC, which is of the same group as the bank. How about this transaction?

From the construct of the question, it quite clearly seems like a P&E transaction. Usually, any lender will seek information on loans taken from others, and more so if there is a stressed loan from a group entity. Therefore, this transaction should be seen as inspired with the intent of getting an NPA/stressed loan cleared in the books of the NBFC belonging to the group.

15. A listed entity is engaged in manufacturing certain products, and has outsourced a part to some job workers. The company has given certain parameters to job workers to buy the raw materials, as in, the kind, quality, grade, etc. Now, there are two situations:

15.1. The job worker can source the raw materials from any supplier of its choice, subject to those overall conditions.

15.2. The company has given strict prescriptions to job workers to buy the raw materials from one of the related parties of the listed entity.

Is the second case a case of RPT, applying the purpose and effect test?

On a first impression, the P&E test does not seem applicable here. The job work carried out by the company with job workers cannot be said to be motivated by the motive of benefiting related parties, who supply materials to the job workers.

However, other than due to the P&E test, prescription on a third party, as a part of the terms of the contract, to have a reciprocal contract with a related party, should amount to an arrangement with a related party. The job worker, in the example above, has to, as a matter of contractual obligation, source certain materials from a related party. A job worker will obviously price the job on cost+margin basis, and if the related party which is supplying materials to the job worker overpriced the supplies, the impact clearly comes on the listed entity.

Therefore, even if we disregard the P&E test, a prescription in a contract with an unrelated party to enter into a contract with a related party should itself be taken as a related party transaction.

16. A group has a trading company and an NBFC. The NBFC provides loans to small businesses which purchase goods from the trading company. Had it not been for the facility so given by the NBFC, the trading company will have to provide a credit period to such businesses.

This is a very common situation - a captive financing entity, which finances supplies by, or supplies to, a related entity. This arrangement may reflect itself in multiple ways:

(a) An auto manufacturer has a financing company, which finances the vehicles made or sold by the OEM.
(b) Supply chain financing - an NBFC finances sales or supplies made to its related party.
(c) Receivables financing - an NBFC finances, by acquiring receivables, for sales made by the related party.
(d) Financing dealers - an NBFC finances the dealers/ customers, who in turn, are able to acquire goods/services from a related party.

In each of these, one has to see the interest of the related party involved.

In case (a), as a matter of practice, the captive NBFC finances vehicles of its group entity. By and large, most automobile makers globally have such an arrangement. The fact that the NBFC finances vehicles made by the related party does not mean there is a transaction with the related party. The consequential impact on the related party is sales-aid, but one cannot say that the NBFC is either transacting with the related party, or transacting with the purpose and effect of benefiting a related party.

In case (b), if and to the extent NBFC has a recourse on its related party, there is a related party transaction.

In case (c), the assignment of receivables is made by the related party, and hence, the transaction is clearly a related party transaction.

In case (d), while the credit is being extended to a dealer/customer, but what matters is, is there a recourse on the related party? If yes, the transaction will be taken as a related party transaction.

17. **Listed entity A provides engineering services to one of its subsidiary S similar to the services provided to its other customers. To provide the engineering service entity A procures certain software licenses from a third-party entity P. Because the software license is going to be used in the services given to the subsidiary S , will this purchase of software license by company A from a third party be construed as a RPT whose purpose and effect is to benefit the related party subsidiary S?**

The answer to this question, as in case of most real life questions pertaining to RPTs, should depend on the complete factual matrix. However, based on what is apparent from the facts provided in the query, while it is clear that the acquisition of the license by the LE does provide a benefit to the subsidiary, however, it possibly cannot be argued that the LE had no other reason to acquire the license, but for benefiting its subsidiary. That is, it does not seem as if the sole or dominant motive of acquiring the license was to benefit the related party. The LE charges for its supplies, and it charges for the use of the license too. Hence, it seems that the transaction is in ordinary course and is arms' length.

18. **Group sourcing of raw materials done by the holding company and later distributed to subsidiaries - does this hit the 'purpose & effect' test?**

Group sourcing of raw materials, finances, manpower, software, etc. are quite common, and are potentially inspired by the inherent economies of scale. While the benefit to the group entities is evident, what is relevant to see is, what was the purpose. If the purpose was group-level economics, it cannot be contended that the transaction was inspired by the view to provide a benefit to a related party.

On the other hand, if the contract with the outside supplier is so structured that the LE pays a higher price, and the related parties pay a lower price, a benefit is clearly flowing away from the LE, and to the related parties.

19. **If a company wants to invest in AIF. Related Party of the Company is a partner in LLP, which is in turn investment manager of AIF. The purpose of the company is to invest, the AIF fund being a good investment opportunity and the effect is benefit of Related Party as Investment manager would be receiving Investment management fees on account of said Investment. Whether the transaction would be RPT from a purpose & effect perspective?**

Purpose of investment is not to benefit the manager. It does not look like a transaction intended to benefit the manager, It may be a collateral benefit.

20. Advances given to unrelated parties which may have effect by way of increase of business of other related listed entities are also to be termed as RPT transaction?

Once again, if we test this transaction on the "purpose" test, the answer will be easy. What was the purpose of the advance? Was the advance given in the ordinary course of business? Or was the advance merely given, unrelated to business or commercial motive, for the purpose of supporting the business of the related party? In that latter case, it is clearly a transaction meeting the P&E test.

21. Should the purpose and effect always be a positive effect? What if the transaction between a listed entity and third party ends up in creating a loss for the related subsidiary. Is that still an RPT under this clause or because there was no benefit provided to the related subsidiary it is outside the purview of RPT?

On the face of it, no one does or engineers transactions for the purpose of taking a loss. Hence, "effect" should be taken as a beneficial or positive effect. However, if a loss to one is compensated by a benefit somewhere else - for example, there is another related entity, which is deriving a reciprocal benefit, there is clearly a transaction inspired by the intent of benefiting a related party.

22. Suppose a listed entity is entering into an ordinary sale transaction with any third party, say X which in turn further processes the material received and then sells the processed goods to the RP of the listed entity. This transaction is done at ALP and is governed by a Tripartite agreement. In this case, whether the said transaction will fall under RPT?

As there is a tripartite agreement between the listed entity, its related party and the third party, this is a case of RPT.

23. A subsidiary of a Listed entity enters into Contract No. 1 with an unrelated party and has a back to back contract no. 2 with the listed entity to service Contract No. 1. Whether Contract No. 1 be a RPT for listed entity?

In this case, the transaction pursuant to Contract 2 is with the subsidiary, i.e. an RP and therefore, is a case of RPT. P&E test is not relevant here as the transaction is being undertaken with an RP to be able to service a contract with an unrelated party. Therefore, Contract 1 is not an RPT.

24. Establishment of purpose and effect criteria in the context of offshoring of business to the parent company by the foreign subsidiary when it contracts with an overseas customer and such offshoring is in the ordinary course of business and at an arm's length.

Ordinary course and arm's length transactions undertaken with a commercial rationale are not covered under P&E test.

25. Mere fact that transaction is ordinary course and arms' length can save a transaction for being categorized under 'purpose and effect'?

Transaction in OCB and arms' length cannot be reasoned to be camouflaged. Thus, not an RPT.

26. Whether incidental benefit is covered even if the main purpose of the transaction is not to benefit RP? for eg - in case Listed entity signs for employee benefit programs such as Sodexo etc. and covers employees of the group companies too for getting maximum discount/benefit, would such transaction qualify P&E test of new RPT norms?

The purpose of P&E test is to detect camouflaged transactions. Transactions undertaken with unrelated parties by negotiating at group level, with an intent to pass on the benefits of economies of scale to the listed entity and subsidiaries has a commercial rationale. Similarly, transactions undertaken for employee benefit in general, cannot be said to be undertaken to benefit one of the employees, being a related party. One will focus on the purpose of undertaking the transaction and not just on the incidental benefit.

27. Company A and B together form a SPV named AB Limited for undertaking construction business in the share equity ratio of 80:20 respectively. As per the SHA between A and B, Company B is required to perform certain obligations, including obtaining government approvals, for commencing the business by AB Ltd. In order to enable B to perform these obligations, A had provided a loan to B. B is not considered as RP by A. Can it be said that A has given a loan to a non-RP (B) for the benefit of SPV i.e AB Limited. Will this be a RPT?

Yes, if the purpose of extending the loan is pursuant to the terms agreed in the SHA, the loan will be said to be furnished for the benefit of SPV AB Limited which will be a related party of A Ltd.

Identification of RPTs with unrelated parties

28. There is an indefinite number of transactions with unrelated parties. How is it possible to scrutinize these transactions for potential P&E test?

The list of transactions with unrelated parties is indefinite, but the list of related parties is definite and ascertainable. The beneficiary of undisclosed RPTs is obviously a related party. Hence, the approach should be to try and track transactions/structures or arrangements structured to benefit such related parties.

29. Why would a related party, who has obviously engineered a transition to fall out of the regulation and control, admit or disclose such transactions?

Obviously, it is counterintuitive to expect the undisclosed beneficiary of a transaction to come out of the shadows and admit the engineered transaction. The very purpose of the camouflage is lost in that case.

However, the law is anti-avoidance, and therefore, a larger purpose it serves is to sound an alarm of caution to the related parties. As they are beneficiaries of the transactions, if detected, they are the ones who would be presumed to have been responsible for structuring such a transaction.

Given the risks of civil and criminal action (see elsewhere) for having engineered such structures, the new regulation would serve as a strong deterrent. RPs should stand up and take notice that they cannot

get away from RPT controls by creating subterfuges, particularly as connecting the dots has become so very easy in today's world of information transparency.

30. How is it possible to implement the P&E approach?

The implementation of P&E approach in the overall RPT framework would broadly require identification of such transactions with the so-called unrelated parties that fall within one or more of the following criteria -

- Not in the ordinary course of business; or
- Does not involve application of commercial wisdom; or
- Lacks monetary consideration or economic substance; or
- Involves conduit/ intermediary that acts as a stopover without any role etc.

To this end, guidance may be drawn from the various global auditing standards on related parties, the most prominent being the ISA 550, which has been adopted by various countries across the world, being the UK, Australia, Singapore, India, Hong Kong etc to name a few, and AS 2410 of PCAOB of the USA.

Sensitizing the RPs, seeking declaration and ensuring existence of effective whistle blower mechanism, should enable the listed entities to implement the P&E approach.

31. Whether indirect benefit also needs to be considered for P&E analysis ?

No. The effect of benefiting the RP should be clear and direct - it is not a collateral benefit, indirect benefit, oblique benefit.

32. How important is it to get a full ownership tree of the entity, to implement the P&E approach?

Given the fact that the tendency to structure disguised RPTs is most common in case of promoter entities (with a view to upstream resources or benefits), it is very important to get a full ownership tree of the entity.

33. For the purpose of P&E test, a listed entity may check the first leg of the transaction done by the listed entity. However, at the second or third instance, if the transaction party, which is unrelated, goes and circulates the results of the transaction back to a related party, how does the listed entity check the same?

While the problem statement is valid, but in general, transactions done with extraneous motive will stand out of the ordinary business transaction. Somewhere, it will reflect itself. Further, we suggest putting a clear and direct responsibility on the related parties **giving a confirmation**, to the effect that the RP has not been responsible, or is not aware of transactions, other than the transactions which are reported by the listed entity, which have the purpose and effect of benefiting the related party.

An indicative format of such confirmation is provided at the end of this FAQ.

34. Many of the related parties are entities, and some of them are listed entities themselves. If confirmations are sought from such parties, they may refuse, or contend that they do not have enough information to give such a confirmation. Further in case of larger entities with a board of directors, who can be expected to give such a confirmation? Should we take confirmation from the business head/ process head?

If the company has transactions with an RP, the company has a relationship, and therefore, it may not be difficult to get confirmations. The confirmation relies on "nothing to my knowledge" or "nothing that I have been instrumental in devising" type language, which should not be objected to by transacting parties. Confirmations are common in case of accounts receivables and payables. Correspondingly, the listed entity itself may also be expected to give a similar confirmation.

The confirmation may be obtained from a responsible officer of the counterparty, who usually authorizes transactions with the company; it does not have to go to the board of directors.

35. While statutory auditors have auditing standards on RPT , they might be looking at RPT with related parties as defined under accounting standards. But RPT on purpose and effect is flowing from LODR regulations and not accounting standards. Does this get covered under auditor checking? And what reporting obligations are there for auditors to ensure RPT compliance under listing regulations ?

Auditing Standards deal with undisclosed RPTs. The responsibility of the auditor is flowing from such auditing standards. The statutory auditor cannot rely on the RP list provided by management. The AC has extended the responsibility of RPT. The AC should engage with the auditor and dig such transactions.

Role of audit committee

36. Is it the responsibility of the audit committee to ensure that transactions with unrelated parties do not have the purpose and effect of benefiting related parties"

The primary responsibility of ensuring that transactions are not structured with the purpose and effect of benefiting a related party is on the related party itself, or such person who has been responsible for structuring the transaction to camouflage the identity of the related party. This is based on the presumption that if a related party is the clear and eventual beneficiary, the related party is the one who has been responsible for structuring the transaction.

However, the audit committee forms an important part of the policing ecosystem of RPTs. The auditors do transactional checking; the audit committee is the bridge between the auditors and the auditee. The audit committee is the audit eye of the board of directors. Increasingly, RPTs are being seen as the domain of the audit committee. It is important to note that RPTs are scrutinised and approved by the audit committee; unless the audit committee escalates them, RPTs do not go to the board at all.

The above underscores the role of the audit committee in approving, and ensuring that unapproved transactions do not take place. Therefore, the audit committee should take the responsibility of taking

such reasonable steps as may be expected to ensure that the outreach of RPT controls is not delimited by manoeuvred transactions or entity control structures.

37. To say that the audit committee should have vigil on P&E RPTs is easy to say; the question is, how do audit committees actually implement it?

Like the role of effective policing also includes sensitisation, the first step in implementing is sensitization. And sensitisation, like charity, begins at home. Therefore, the first task is self-sensitization of the audit committees. Many things are less attended and overlooked due to lack of sensitization. A vigilant audit committee should:

(a) Engage with the promoters and KMPs, asking them for transactions that do not appear to be in ordinary course of business. Significant transactions come to light on careful review of the financial statements.
(b) Engage with the auditors. Auditors are, by far, the most crucial element in the ecosystem, as they vet transactions. Auditors often rely on the statement of "related parties" prepared by management. However, they come across transactions which seem to be lacking commercial expediency, and it is easy for them to report such parties and transactions to the audit committee.
(c) Engage with senior management in finance, procurement and marketing to ensure that non-routine transactions are brought to notice of the audit committee if there are reasons to suspect vested interests.
(d) Strengthen the whistle blower mechanism for bringing up disguised transactions. This mechanism is organisation-wide, and may be instrumental in better controls.
(e) Strengthen code of conduct and ethics to include transactions involving conflicts of interest at all levels.

38. Are we envisaging a forensic approach for the audit committee?

Not at all. The analogy for effective policing will be helpful here too. A vigilant, agile police gives courage to the honest, and fear to the dishonest, and therefore, succeeds in promoting proper conduct. However, if breaches in right conduct are found, the police takes up an investigative role.

In the same manner, a vigilant and agile audit committee spreads awareness around, and is generally effective in better governance. But if instances of lapses are found or suspected, the audit may undertake investigation, with necessary professional help.

39. Can the audit committee require the compliance team to carry the P&E test? What actions or confirmations may be expected by the audit committee to satisfy itself about the P&E test? Where will such actions or findings be minuted?

To reiterate, a properly sensitized audit committee does not have to view every transaction with skepticism. Therefore, there is no need to carry a roving enquiry, subjecting every ordinary transaction to a potential P&E check. Examples or potential indicators of transactions which may raise a red flag have been highlighted by auditing standards. Audit committees may pay particular attention to these transactions, which are typically not in ordinary course.

Audit committee may engage either statutory auditors, or internal or concurrent auditors to report transactions which may lack commercial expediency. It may also ask for a report of deviations from the typical transaction approval hierarchy, captured by the ERP/SAP system.

The checking of P&E test is not a periodical exercise - it is a continuing constructive probe. However, audit committee would need to minute their examination and results thereof. Therefore, at least at the time of approving annual financial statements, audit committees may require management report on specific transactions in the financial statements, and try to rule out any RP interest therein.

40. Entities may have complicated offshore ownership structure, offshore businesses, finances, etc. In such cases, how does the sweep of the audit committee's checking cover different jurisdictions, many of which are admittedly opaque?

The more complicated the ownership structure, with entities in different jurisdictions, particularly those with known lack of transparency, the more pressing is the need for the audit committee's surveillance over these transactions.

As an important step towards ensuring proper P&E surveillance is to get the ownership structure of the entity, including upstream and downstream entities. If there are transactions with the entities forming part of the ownership tree, with proper identification of beneficial ownership at each stage, the audit committee may be watchful of these transactions, regardless of whether they form a part of the RP list or not.

Disclosure of RPT

41. Whether the P&E approach will have any impact on disclosures of RPTs?

In case the listed entity or any of its subsidiaries are able to identify RPTs after applying the P&E test, the listed entity will be required to disclose the same in its disclosures submitted to the stock exchanges under Reg. 23 (9) along with requisite details.

RPT Policy

42. Whether this calls for any amendment to the RPT policy of the listed entity?

Presently, and in general, the policy only covers the same as a part of the definition, where provision of law has been reproduced. The guidance on manner of identifying, approach to be followed, confirmations or declaration to be taken etc. has not been incorporated by listed entities. The purpose of the RPT policy is to determine the materiality of RPTs and also manner of dealing with RPTs. Further, the RPT policy is not entity specific but sets the tone for compliance to be ensured at group level. Accordingly, the listed entities may be encouraged to revisit its existing RPT policy or consider having a separate SOP for dealing with the purpose and effect aspect in order to serve as a guidance.

Annexure - [Indicative] format of declaration from related parties for P/E transactions

To
The Audit Committee
ABC Ltd.

Sub: Declaration in respect of transactions covered under 'Purpose and Effect' test

I/We, hereby declare, affirm, and undertake that -

- I/We am/are neither responsible for, directly or indirectly, nor I/We am/are aware of any transactions, other than the transactions which are reported by ABC Ltd., which has/shall have the purpose and effect of benefitting [me/RP], whether directly or indirectly, and/or, wherever applicable, any of my relatives or any of the affiliates/group entities/promoter entities of the [RP] and/or their directors/officers, as the case may be (hereinafter referred to as 'Subject Transaction').
- I/We shall put in place necessary safeguards, including adequate sensitisation, to ensure that my relatives, our officers and employees (as the case may be) act in good faith and exercise reasonable diligence while entering into any transaction
- At any time, if it comes to my/our knowledge that any of my relatives/our officers (as the case may be) are involved in any such Subject Transaction, we shall take immediate steps to disclose the same to you.

I/We understand that, if the aforesaid declaration is found to be false or incorrect, the subject transaction shall be voidable at the option of ABC Ltd, and [I/RP] and any of its relatives, directors, officers, and employees (wherever applicable) shall be jointly and severally liable for any costs, losses, etc. suffered by ABC Ltd., without prejudice to any regulatory action which can be taken against [RP] and/or its directors, officers, employees (wherever applicable).

_____

Signed by:
Designation:
[RP]