

**ADEQUACY OF RULES REGARDING RELATED PARTY
TRANSACTIONS**

T-6499

Thesis Statement

Rules and regulations need to be enhanced in Pakistan in
order to avoid abusive related party transactions



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A dissertation submitted in partial fulfillment
of the requirements for the degree of
MASTER OF LAWS
(Faculty of Shariah and Law)
International Islamic University, Islamabad

2009

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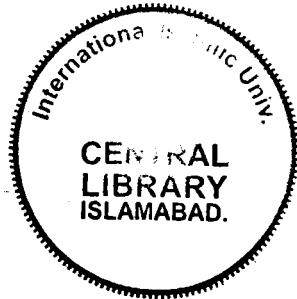
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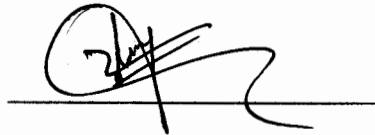
Final Approval

It is certified that we have read the dissertation submitted by Nuzhat Mahmood Khan entitled "Adequacy of Rules Regarding Related Party Transactions" as partial fulfillment for the award of the degree of LL.M (Corporate Law).

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DEDICATION

This research work is dedicated to my Parents

Mr. and Mrs.

Muhammad Mahmood Khan

Nuzhat Mahmood Khan

ACKNOWLEDGMENTS

I owe my gratitude to Mr. Imran Ahsan Khan Nyazee for his guidance in selecting this research topic.

I would like to acknowledge the continuous guidance received from my supervisor, Mr. Muhammad Zubair Abbasi in writing this thesis. His great knowledge and experience became a source of learning during the completion of this thesis.

I also acknowledge the assistance of my sister Riffat Mahmood Khan in choosing this research topic and in composing this thesis.

I am much grateful to my family especially my parents for their continuous moral support and prayers which enabled me to write this thesis.

Nuzhat Mahmood Khan

List of Abbreviations

| | |
|---------------|--|
| AS | Accounting Standards of India as formulated by ICAI |
| AICPA | American Institute of Certified Public Accountants |
| BSE | Bombay Stock Exchange |
| CCG | Code of Corporate Governance |
| FASB | Financial Accounting Standard Board of America |
| IAASB | International Auditing Assurance Standards Board |
| IAS | International Accounting Standards as formulated by IASB |
| IASB | International Accounting Standard Board |
| ICAP | Institute of Chartered Accountants of Pakistan |
| ICAI | Institute of Chartered Accountants of India |
| ISA | International Auditing Standards |
| KSE | Karachi Stock Exchange |
| NASDAQ | National Association of Securities Dealers Automated Quotation |
| NYSE | New York Stock Exchange |
| PCAOB | Public Company Accounting Oversight Board |
| RPT | Related Party Transaction |
| SAS | Statement on Auditing Standards of AICPA |
| SEC | Securities and Exchange Commission (USA) |
| SECP | Securities and Exchange Commission of Pakistan |
| SOX | Sarbanes Oxley Act 2002 |

ABSTRACT

The issue of related party transactions requires particular attention because of the risk of fraud attached to them which could affect the company and its shareholders adversely. If these transactions are not fair, they can bring the company at the edge of bankruptcy as happened in USA in Enron and in Europe in Parmalat cases and more recently in India in Satyam case. This study is an attempt to analyze the existing legal framework of related party transactions in Pakistan in comparison with other developed and developing countries like USA and India respectively. It is found that in order to regulate such transactions and to bring transparency in them a complete set of rules is required, which would include approval of these transactions from the majority of independent directors and their review by the audit committee (which must comprise of independent directors and financially literate persons) and their full disclosure in the financial statements.

It has been observed that the existing legal framework in Pakistan is not efficient to prevent abuse of these transactions as it is limited in its scope because it is applicable on listed companies only while majority of companies in Pakistan are unlisted. It is also found that Pakistan instead of formulating its own standards of accounting and auditing simply adopted the International Accounting Standards. Analysis of case law revealed that the punishments prescribed for non compliance of the relevant provisions dealing with related party transactions are also not strict to deter the wrong doers. It is found that due to the lenient rules, chances of fraud through such transactions are higher. At the end some suggestions have been prescribed in order to improve the existing legal framework of related party transactions in Pakistan.

INTRODUCTION

Adequacy of Rules regarding Related Party Transactions

Rules and regulations need to be enhanced in Pakistan in order to avoid abusive related party transactions

Previously related party transactions may not have held much meaning for lay investors but after the big corporate cases in USA, like Enron and Tyco, they certainly understand this term.¹ Commonly officers, directors, five percent beneficial holders, and close family members of these individuals and subsidiary of the company are known as related party.² Transaction between the company and these related parties are known as related party transactions. For example, granting of loan by the company to any of its director.

As related party transactions are normal part of business activities but some times these transactions have been conducted by fraud with the aim to provide benefit to the related party and causing loss to the company. Therefore, strict rules are required to regulate them because these transactions carry threat of fraud as well. When these transactions are

¹ Aarati Krishnan, Related party transactions: Companies tread a thin line, "Business Line"(Dec 08, 2002), <http://www.thehindubusinessline.com/iw/2002/12/08/stories/2002120800520600.htm>. (accessed July 20, 2008).

² Robert D. Strahota, "A Framework for Disclosure and Regulation of Related Party Transactions"(paper presented at 5th Meeting of the South East Europe Corporate Governance Roundtable Ohrid, Macedonia, June 10-11, 2004), <http://www.oecd.org/dataoecd/55/55/32387366.PPT>. (accessed July 12, 2008).

fraudulent in such situation these transactions are not conducted by following proper procedure i.e., they are either conducted without taking any approval or are not disclosed in the financial statements. If rules governing these transactions are not rigid, these transactions can be disguised by fraud causing a great loss and damage to the company. Enhanced rules and regulations are required to avoid abusive related party transactions and to increase transparency in the area of related party transactions. In fact financial system can be benefited if related party transactions are reasonable, but if these transactions are unfair they can cause serious losses to the company and also to its shareholders.

At international level there is current trend towards the corporate law reform on many issues and related party transaction is one of them. For example in Malaysia corporate law reform committee was set up in 2003, the purpose of which was to bring modification in the provisions relating to different area of corporate law included related party transactions.³ USA has also brought reforms in its existing rules regulating related party transactions.⁴ In Pakistan rules relating to related party transactions were incorporated in 2003 by amending the fourth schedule of the Companies Ordinance 1984 and now with the passage of time there is also need to bring out reforms in this area.

³ See Janine Pascoe, Key developments in Corporate Law Reform in Malaysia. <http://www.law.usyd.edu.au/~parsons/CLTA/PascoePaper.pdf> (accessed July 30, 2008).

⁴ See, e.g., Paul, Weiss, *SEC Adopt New Executive Compensation And Related Party Disclosure Rules*(Aug 17, 2006),11, <http://www.paulweiss.com> (accessed July 18, 2008).

Directors and all related party transactions will also be formally approved by the directors. After approval these transactions will be reviewed by the audit committee. Then these transactions will be disclosed in the financial statements. These transactions are then subject to audit by the external auditor. Pakistan has adopted the International Auditing Standards but auditors do not mandatorily follow them while auditing related party transactions.

In fact in Pakistan rules and regulations regarding related party transactions are not so efficient and there are many loopholes in them, hence fraudulent related party transactions can easily occur, causing serious loss to the company.

The purpose of this dissertation is to study and analyze the present rules and regulations existing in Pakistan dealing with related party transactions and its concerned issues and to make recommendations to improve these rules and regulations to avoid the abuses of such transactions in order to protect the interest of investors and to protect the company from loss.

No systematic research has been done on this issue in Pakistan. Therefore I will try to make small contribution in this area through this dissertation. Basically there are two reasons to research on and to address this issue. Firstly in Pakistan mostly general public is not aware of this term and secondly these transactions can cause loss to the companies, working within Pakistan, easily as the rules in Pakistan dealing with these transactions are not strict.

The study will focus firstly to see the scope of these transactions in business area. Then it will be directed to see the general legal framework of related party transactions in different

jurisdiction and also sketch the improvements which they have incorporated with the passage of time in this area. Then it will analyze the existing legal framework in Pakistan regarding related party transactions and highlight the area in which improvement is required. Finally this dissertation will make concluding remarks and will propose recommendations in this regard for the purpose of bringing improvement in existing legal framework which if implemented can actively protect the company as well as the shareholders from the abuse of such transactions.

CHAPTER 1

INTRODUCTION & FUNDAMENTAL CONCEPTS

Every transaction a company undertakes is either with a related or an unrelated party, i.e., with a party who has some extra-transaction relationship with the company through employment, ownership, or both; or with a party who has no extra-transaction relationship with the company.¹ Related Party generally includes officers, directors, five percent beneficial holders, and close family members of these individuals and subsidiary of the company,² and a business deal or transaction between them and company is known as related party transaction. For example, a business transaction between a major shareholder and the company.

Sometimes these transactions have been motivated by fraud, and are called abusive related party transactions. Providing a loan to a related party below market interest rate is an example of such transactions. Abusive related party transactions are motivated to provide personal benefit to related party at the cost of company and causes loss to the company and its shareholders.

¹ See, Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of Related Party Transactions in Fraudulent Financial Reporting* (dec-2006), 05, http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July 18, 2008).

² Robert D. Strahota, "A Framework for Disclosure and Regulation of Related Party Transactions"(paper presented at 5th Meeting of the South East Europe Corporate Governance Roundtable Ohrid, Macedonia, June 10-11, 2004), 03, <http://www.oecd.org/dataoecd/55/55/32387366.PPT> (accessed July 12, 2008).

For the fair conduct of these transactions, and to avoid the disadvantages of such transactions almost all countries have formulated a legal framework.

Some countries require such transactions to be approved by shareholders, and in some countries there is requirement to obtain the approval of such transactions from the board of directors of the company. While the requirement of disclosing such transactions in financial statement is common.

In Pakistan there also exist some rules and regulations regarding related party transactions.

The purpose of this research is to study and analyze the present rules and regulations existing in Pakistan regarding the related party transactions and its concerned issues and to make recommendations to improve these rules and regulations to avoid the abuses of such transactions in order to protect the interest of investors and to protect the company from loss.

Before analyzing the rules and regulations it is necessary to see and analyze in detail who is a related party and what includes a related party transaction.

1.1 Who is a Related Party?

Related party means Chief Executive Officer and next four highest paid officers, all directors, more than five percent beneficial owners of equity securities, their immediate family members and entities in which these persons are officers, directors or owners of more than a specified percentage of the equity.³

³ Robert D. Strahota, "A Framework for Disclosure and Regulation of Related Party Transactions"(paper presented at 5th Meeting of the South East Europe Corporate Governance Roundtable Ohrid, Macedonia, June 10-11, 2004), 03, <http://www.oecd.org/dataoecd/55/55/32387366.PPT> (accessed July 12, 2008).

The concept of related party is taken in the same meaning almost in every country and includes the following persons as related party in relation to the company.

1. Persons qualify by virtue of involvement in the company's management;
2. Persons qualify by virtue of participation in the company's share capital;⁴
3. Persons qualify in the light of control criterion; and
4. Persons qualify by virtue of family relations.⁵

(i) Persons qualifying as related parties by virtue of their involvement in the management of a company:

Generally, it is considered that the members of management of a company, and the key executive officers like directors and chief executive officer qualify as related party to the company in whose management they are concerned.⁶ This principle is applicable even if the manager is a legal entity and covers direct or indirect involvement.

(ii) Persons qualifying as related parties by virtue of participation in the company's share capital:

Shareholders who hold more than the prescribed amount of shares of a particular company either directly or indirectly are treated as related party to that company.⁷ Generally, to

⁴ Laura Luputi, *Reporting Related Party Transactions and conflict of interest*,(n.d.),7-8, www.oecd.org/dataoecd/55/34/32387391.pdf (accessed July 12, 2008).

⁵ Ibid.

⁶ Ibid.

⁷ Laura Luputi, *Reporting Related Party Transactions and conflict of interest*,(n.d.), 08, www.oecd.org/dataoecd/55/34/32387391.pdf (accessed July 12, 2008).

qualify as a **related party**, a shareholder should have at least a significant interest, even if holding disclosure requirements apply to lower levels of shareholding.⁸

(iii) Persons qualifying as related parties in light of the ‘control’ criterion:

Generally, according to this principle the persons treated as related parties include the person exercising control over another party and that other controlled person; the persons controlling together a third party and the persons under the control of a third party.⁹The ‘control’ criterion also covers direct or indirect control.

(iv) Persons qualifying as related parties by virtue of family relations:

In general the spouses and close relatives of directors, officers and managers are also considered as related party to the company, there are differences as regards the degree of relationship and affinity.¹⁰ Generally, this standard is also used for determining indirect involvement in management, indirect participation towards the share capital or indirect control.¹¹

⁸ Ibid.

⁹ See “Summaries of international financial reporting standard” *IAS PLUS*, <http://www.iasplus.com/standard/ias24.htm> (accessed July 18, 2008).

¹⁰ Ibid.

¹¹ Ibid.

1.2 Related Party Transactions:

Related Party Transaction means the transactions between the company and its officers, directors, and principal shareholders.¹² In accounting terminology related party transactions means business or other transaction between persons who do not have an arm's-length relationship, e.g., a relationship with independent, competing interests.¹³

The most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a higher level of scrutiny.¹⁴

The received wisdom is that related party transactions play a significant and legitimate role in a market economy, and firms, trade and foreign investment is often facilitated by such transactions.¹⁵ These transactions logically fulfill other economic demands of a company such as by providing access to in-depth skills and expertise.¹⁶ For example, a non executive director possesses an extensive knowledge of firm-specific activities as well as a skill that the company demands such as legal expertise. The company engaging such non executive

¹² Listing Manual 303A.01 of NYSE,
<http://nysemanual.nyse.com> (accessed Aug 19, 2009).

¹³ New York Society of CPAs, *Accounting Terminology Guide*, (n.d.),
http://www.nysscpa.org/prof_library/guide.htm (accessed, Nov 16, 2008).

¹⁴ Ibid.

¹⁵ Joseph A. McCahery and Erik P.M. Vermeulen, *Corporate Governance Crises and Related Party Transactions: A post Parmalat agenda*, (n. d.), 228,
<http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 18, 2008).

¹⁶ Elizabeth A. Gordon, Elaine Henry, *Related party transaction and earning management*.(Abstract),(Nov 2005),
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=612234 (accessed July 20, 2008).

director, who is also a related party, to provide the service could be more effective than hiring an outsider as he possesses an extensive knowledge of the firm.¹⁷

There are many examples of related party transactions that are beneficial for companies. Such as transfers of research and development with related party,¹⁸ guarantees from holding company to foreign subsidiary; the sale of receivables to a special purpose entity, and a leasing or licensing agreement between a parent and a foreign subsidiary.¹⁹

Although related party transactions play important and legitimate role in an economy but if left unchecked, could promote opportunism. Through related party transactions, controlling shareholders and managers may extract private benefits of control.²⁰ For the fair conduct of these transactions it is necessary that these transactions should be conducted at arm's length price²¹.

¹⁷ Elizabeth A. Gordon, Elaine Henry, and Darius Palia, *Related Party Transactions: Association with Corporate Governance and Firm Value*(2004), 07,

<http://www.nd.edu/~carecob/Workshops/Gordon.pdf> (accessed Aug 06, 2008).

¹⁸ *Summaries of international financial reporting standard* IAS PLUS, Deloitte, <http://www.iasplus.com/standard/ias24.htm> (accessed July 18, 2008).

¹⁹ Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda* (n.d.), 228, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 12, 2008).

²⁰ Joseph A. McCahery, "The Role of the Board in Related Party Transactions,"(paper presented at 2006 OECD Policy Dialogue on Corporate Governance, India, February 16-17, 2006), www.nfcgindia.org/Jospeh%20A.%20McCahery.ppts (accessed July 7, 2008).

²¹ Arm's length price means a price which is used with unrelated party.

A series of related party transactions can effectively enabled certain executives to misrepresent the financial condition of the company,²² therefore, for the fair conduct of related party transactions it is necessary that these transactions should be approved by the board of directors or by shareholders, and disclosed in the financial statements. Without disclosure to the contrary, there is a general presumption that the transactions mentioned in the financial statements have been conducted on an arm's-length basis between independent parties.²³ Disclosure in financial statement is also necessary for the benefit of those who have invested in that company and for those who do business with that company.²⁴

1.3 Concept of Related Party and Related Party Transactions under International Accounting Standards:

International Accounting Standard²⁵ (IAS 24) deals with related party disclosure. IAS 24 provide the definition of related party and related party transaction which are as follow.

²² Catherine M. Dalton, David H. Jacobs, Dan R. Dalton, and Hrold A. Poling, "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006), <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 6,2008).

²³ Shannon Pratt, Robert F. Reilly, Robert P. Schweihs, Inc NetLibrary, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*(McGraw-Hill Professional,1994),268.

²⁴ Smith and Keenan's, *Company Law for Students*, 10th ed., (London: Pitman publishing, 1996), 407.

²⁵ International Accounting Standards (IAS) are formed by International Accounting Standards Board (IASB), based in London, began operations in 2001. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements.

(i) Related Party:

Related Parties IAS 24.9

“A party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries, and fellow subsidiaries);

(ii) has an interest in the entity that gives it significant influence over the entity; or

(iii) has joint control over the entity;

(b) the party is an associate of the entity;

(c) the party is a joint venture in which the entity is a venturer;

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled, or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity”.²⁶

(ii) Related Party Transactions:

According to International Accounting Standard (IAS 24.9) a related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.²⁷

²⁶ Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda*, (n.d.), 233, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 18, 2008).

²⁷ Ibid.

(iii) Related Party Transactions Disclosure:

International Accounting Standards also provides the provisions for the disclosure of related party transactions.

According to International Accounting Standard (IAS 24.12) an entity must disclose in its financial statements the name of its parent and, if different, the ultimate controlling party, regardless of whether there have been transactions between such parent and subsidiary.²⁸ According to IAS 24.16 compensation given by the company to its key management must also be disclosed.²⁹

According to IAS 24.17-18, firms must give disclosure of related party transactions which includes the amount of the transactions, the amount of outstanding balances, including terms and conditions and guarantees, provisions for doubtful debts related to the amount of outstanding balances and expense recognized during the period in respect of bad and doubtful debts due from related parties.³⁰

It is also mentioned in the International Accounting Standard 'IAS 24.21' that where the firm states that related party transactions were made on terms that are common in arm's length transactions, it must provide proof as such.³¹

²⁸ IAS 24. 12, "Summaries of International Financial Reporting Standard" *IAS PLUS*, <http://www.iasplus.com/standard/ias24.htm> (accessed July 18, 2008).

²⁹ Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda*, (n.d.), 234, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 18, 2008)

³⁰ Ibid.

³¹ Ibid.

Although the concept of related party transaction and their presence in companies are inherent in corporate structure and these transactions are also beneficial for companies,³² but sometimes the purpose of these transactions is not fair, and are motivated to defraud the company and to provide personal benefits to related party at the cost of company. In such situation these transactions are known as abusive related party transaction.

1.4 Abusive Related Party Transactions:

Related Party Transactions which are not conducted at arm length price and are motivated by fraud to misappropriate the assets of the company, and to give personal benefits to related party at the cost of company are known as abusive related party transactions.

As for related party transaction proper approval and disclosure is necessary, but the abusive related party transactions do not disclose the true information in the financial statement or in other words misstated in the financial statement. Often these transactions have been mentioned in the financial statement without disclosing relationship of the transacting party. The purpose of abusive related party transaction is not to misstate the financial accounts and financial statement but to give benefits to related party at the cost of company.

³² Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda*, (n.d.), 228, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 18, 2008).

1.5 Different forms of abusive Related Party Transactions:

Abusive related party transactions may occur in different forms which are following.

1.5.1 Borrowings from (loans to) Related Parties:

The most common form of abusive related party transaction is loans to related parties. Making loan with no scheduled terms for when and how the loans will be repaid is usually motivated to gain unreasonably at the cost of the company and is therefore considered as abusive related party transaction.³³

Either borrowing from a related party at above-market interest rates, or lending to a related party at below-market interest rates can transfer wealth to the related party.³⁴

Example:

In case of WorldCom, a company of USA, the abusive related party transactions of granting loans were involved. Related party transactions in the form of personal loans to corporate officers that were ultimately forgiven were key causes of the demise of Adelphia Communications and WorldCom.³⁵

³³ Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of Related Party Transactions in Fraudulent Financial Reporting* (dec-2006),17, http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July 18, 2008).

³⁴ Ibid.

³⁵ Catherine M. Dalton, David H. Jacobs, Dan R. Dalton, and Hrold A. Poling, "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006),

Example:

In another case of USA Company Tyco, this form of abusive related party transactions were involved. In this case top executive at Tyco improperly granted themselves loans from the company at zero or low interest rate. They used the proceeds for personal expenses, and secretly arranged for some of the loans to be forgiven.³⁶

1.5.2 Sales of asset to (purchases from) Related Parties:

Sale of real estate at price that extensively differs from its appraised value³⁷ is a kind of abusive related party transaction as sales of assets to a related party at low-market prices can transfer wealth to related party. Similarly purchase of non-existent assets or over-priced assets by the company can transfer wealth to the related party and causes loss to the company hence is a form of abusive related party transaction.³⁸ Sometimes a situation arise in which directors make decision to sell the assets at high prices than their market value and

<http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 06, 2008).

³⁶ Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of related party transactions in fraudulent financial reporting* (dec-2006), 20,

http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July 18, 2008).

³⁷ *Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors* (Prepared by the staff of the American Institute of Certified Public Accountants), 24,

<http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 18, 2008).

³⁸ Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of related party transactions in fraudulent financial reporting* (dec-2006), 16,

http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July, 18, 2008).

gain personal profits and mention in the financial statements the sale price as less than actual sale amount.³⁹

Example:

Related party transactions were also involved in Enron's case. Most of the Enron related party transactions involved sale of assets to non-consolidated special purpose entities in order to report gains and to avoid reporting losses.⁴⁰ In this case related-party transactions with "special-purpose entities"⁴¹ were used to help the company misreport their accounting numbers.⁴²

1.5.3 Sales of goods and services to (purchases from) Related Parties:

Generally the common type of abusive related party transaction is payment to company officers for the non existent services.⁴³ Selling of goods and services or purchasing of goods or services to a related party at price that differs significantly from its market value is also a kind of abusive related party transaction.⁴⁴

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Special purpose entities(SPE) some times called special purpose vehicle can be defined as an entity created to carry out a specific or limited purpose. The creator of the Special Purpose entity is called the sponsor. The (SPE) can take any organizational form so the sponsor can set it up as a corporation, partnership, trusts or joint venture. Some of the most common things (SPE) are used for include selling or transferring assets to the (SPE), all sorts of leasing activities, creating research and development vehicles and as hedging devices. The assets passed by the company to the (SPE) act as collateral to cover any losses sustained by the investors.

⁴² Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of related party transactions in fraudulent financial reporting* (dec-2006), 4, http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July, 18 2008).

⁴³ Ibid.

⁴⁴ Ibid, 12.

Sometimes abusive related party transactions occur through fictitious sales to a related party and mischaracterizing receipts as revenues, the purpose of which is to overstate revenue.⁴⁵

Abusive related party transactions may also occur through genuine sales to a related party at below-market prices which can transfer wealth to the related party.⁴⁶

Example:

For example, a company contract with its franchisee on the board, who might also be a relative of a senior manager, for providing consultancy and overpay him for his advice.⁴⁷ In such type of transaction company purchases the services of the related party and if pay at above market price without disclosing this fact in the financial statement then it would be abusive related party transaction. As the purpose of this transaction seems to provide benefit to related party at the cost of company.

1.5.4 Investments in (sales of equity to) Related Parties:

Investment in the equity of a related party made by the company, if is not reported correctly, can lead to the overstatement of assets and of regulatory capital.⁴⁸ Similarly investment

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Related party transactions: cautionary tales for investors in Asia.(Report prepared by Asia Pacific office of the CFA Institute Centre For Financial Market Integrity, Jan,09),06.
<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1?cookieSet=1> (accessed Aug, 03, 2009).

⁴⁸ Elaine Henry, Elizabeth A. Gordon, Tim Louwers *Role of related party transactions in fraudulent financial reporting*. (Dec-2006), 21,
http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July 18, 2008).

made by a related party in the company's equity, if reported incorrectly, can mislead investors about insider activity.⁴⁹ Finally investing in the equity of a related party at above-market prices, or selling an equity interest to the related party at below-market prices are the forms of abusive related party transactions as these transfer wealth to the related party at the cost of company.⁵⁰

Example:

This type of abusive related party transaction was conducted in Hollinger Company of USA. It was a newspaper publishing company. The Chief Executive Officer of Hollinger Company authorized the company to invest \$2.5 million in the capital fund of a business enterprise with which he and other top executives were affiliated. They wanted to get personal benefits. The investment was not disclosed.⁵¹

1.6 Conclusion:

Abusive related party transaction is not a separate phenomenon but a separate term for related party transactions the purpose of which is to misappropriate the assets of company and to provide benefits to related party or to extract personal benefits by the management at

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ See, J. E. Boritz, L. A. Robinson, *HOLLINGER INTERNATIONAL INC.* (May, 2004), http://accounting.uwaterloo.ca/ethics/Management_Fraud/Hollinger_case_V10.doc (accessed Sep 27, 2009).

the cost of company and ultimately causes loss to the company and its shareholders. In this situation these transactions are either not approved by the directors or does not disclose in the financial statements as related party transactions. Abusive related party transactions limit the availability of external finance and lead to financial under development.⁵² At their worst these transactions played a key role in some of the corporate failures in recent history which in turn, were responsible for whipping out millions of money in shareholder value and decreasing overall investor confidence in the capital market.⁵³ In order to avoid such abusive transactions it is necessary that proper rules should be made. Proper authorization for every related party transaction needs to be taken from either shareholders or from board of directors, majority of whom should be independent. Auditors can also play a good role in the detection of these transactions with undisclosed relationship. Powers and role of auditor should be enhanced in the detection of these transactions from the balance sheet, with undisclosed relationship.⁵⁴ For the fair conduct of related party transactions and to avoid abusive related party transactions legislation is made in almost every country.

⁵² Joseph A. McCahery, "The Role of the Board in Related Party Transactions,"(paper presented at 2006 OECD Policy Dialogue on Corporate Governance, (India, February 16-17, 2006), 04 <http://www.oecd.org/dataoecd/51/34/37175408.pdf> (accessed Dec, 20, 2008).

⁵³ Related party transactions: cautionary tales for investors in Asia.(Report prepared by Asia Pacific office of the CFA Institute Centre For Financial Market Integrity, Jan,09),o6. <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1?cookieSet=1> (accessed Aug, 03, 2009).

⁵⁴ See e.g., Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*,(Sep 8, 2004),16, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09_08/Related_Party_Transactions.pdf (accessed July, 20, 2008).

CHAPTER 2

LEGAL FRAMEWORK REGARDING RELATED PARTY TRANSACTION

The history of Related Party Transactions can be traced back to the emergence of corporate type of business after industrial revolution. These transactions first came into spotlight in 1973 when U.S. Financial Corporation used these transactions to create millions of dollars of profits and blew up its per share earnings and price and resulting into bankruptcy of the company.¹

The issue of related party transactions again became a hot topic after the recent corporate frauds in the USA like Enron and Tyco, which involved related party transactions in one way or the other.²

In fact most of the transactions between a company and its officers or directors are not inherently wrong or improper, such transactions and relationships are often in the best interests of a company and its shareholders, offering efficiencies and other benefits that

¹ Muhammad Zakir Hussain Sharkar, Md Abdus Subhan, Shahida Sultana, "Association between corporate governance and related party transactions: A case study of banking sector of Bangladesh" *BRAC University Journal*, vol. 4, no.1(2007),32.

² Ibid.

might not otherwise be available.³ Sometimes it becomes unavoidable for the company to enter into transactions with related parties in order to maximize the benefits to the shareholders.⁴

Although all related party transactions are not illegal but they have the potential to raise red flags more easily than other transactions. Therefore legal framework for related party transaction is necessary.⁵

Almost all the countries have formulated legal framework for related party transactions, which is as follow.

1. Approval of Related Party Transactions
2. Review by Auditing Committee
3. Disclosure of Related Party Transactions
4. Auditing of Related Party Transactions
5. Strict Penalties

³ Adam O. Emmerich, Craig M. Wasserman, Lawrence S. Makow, Laura E. Munoz, *Related Party Transactions*, (jan,05, 2004),03

<http://www.complianceweek.com/s/documents/wlrk-011304.pdf> (accessed, Aug, 03, 2009).

⁴ Muhammad Zakir Hussain Sharkar, Md Abdus Subhan, Shahida Sultana, "Association between corporate governance and related party transactions: A case study of banking sector of Bangladesh" *BRAC University Journal*, vol. 4, no.1(2007),31.

⁵ Catherine M. Dalton, David H. Jacobs, Dan R. Dalton, and Hrold A. Poling, "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006), <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 6, 2008).

2.1 Approval of Related Party Transactions:

Related party transactions are either approved by the board of directors or by majority of shareholders all over the world.

2.1.1 Approval of Related Party Transactions by Board of Directors:

The term "board" has different meanings in unitary and two-tier systems. A unitary board consists of executive and non-executive directors whereas in a two-tier system the term "board" is distinguished between the management board and supervisory board.⁶ In the management board members have executive responsibilities while in the supervisory board members are responsible for the monitoring and supervision of the company's management.⁷ Mostly countries in the world follow the practice of unitary board system.⁸

In many jurisdictions there is rule to take the approval of related party transactions from board. When the transaction is between the company and any of its director, which is also a related party transaction then the general rule which is followed in almost every jurisdiction is that the interested director will not vote in the board meeting regarding the approval of that particular transaction.⁹

⁶ Supachai Panitchpakdi, *Guidance on good practices in Corporate Governance Disclosure* (United Nation Conference on trade and development), (United Nation –New York and Geneva, 2006), 11.
http://www.unctad.org/en/docs/iteteb20063_en.pdf (accessed July, 30, 2008).

⁷ Ibid.

⁸ Ibid.

⁹ See e.g., section 216 of Companies Ordinance 1984 of Pakistan and also see, section 300 of Companies Ordinance 1954 of India.

Requiring or encouraging disinterested board approval of conflicted transactions which are also related party transactions have two virtues, firstly compliance is relatively cheap for public companies, and it also encourages efficient transactions. In fact board approval may encourage value increasing transactions by insulating them from outside attack.¹⁰

But this requirement is more useful when the board consists of mostly independent directors because the directors may be disinterested in a transaction but if they are not independent there is probability that they may come under the influence.

The requirement of approving related party transactions by board of directors is common in many jurisdictions but in order to get the positive result of this practice it is necessary that board must consist of majority of independent directors so they can take the good decisions prevailing the interest of the company and that of the shareholders. The large proportion of independent directors act as a high barrier to prevent the managers from engaging in self dealing.¹¹

¹⁰ Reinier Kaarkman, Henry Hansmann, Gerard Hertig, *The Anatomy Of Corporate Law : A Comparative and Functional Approach* (Oxford University Press, 2004), 109.

¹¹ Related party transactions: cautionary tales for investors in Asia. (Report prepared by Asia Pacific office of the CFA Institute Centre For Financial Market Integrity, Jan, 09), 40.

<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1?cookieSet=1> (accessed Aug, 03, 09).

At international level there is a trend to increase the number of independent directors on the board. For example, in US, the board of directors of listed companies comprises of majority of independent directors.¹²

In U.K board of directors is required to have a balance of executive and independent non-executive directors so that no individual or small group of individual can control the board decision making.¹³ In Korea, the listing rules require that companies have at least one-fourth or no fewer than three of its director on board to be independent.¹⁴

In Hong Kong, the requirement of independent directors on the board as mentioned in the listing rules is that companies must have at least three independent directors.¹⁵ In China, the requirement according to the Corporate Governance Code is that one-third of the board should be independent.¹⁶ In Pakistan the requirement of independent directors on the board as mentioned in the Code of Corporate Governance 2002 is that board should consist of twenty five percent non-executive directors including one independent director representing minority shareholders.¹⁷

¹² Ibid.

¹³ Ibid.

¹⁴ Ibid, 35.

¹⁵ Ibid

¹⁶ Ibid

¹⁷ See Code Of Corporate Governance 2002 of Pakistan.

2.1.2 Approval of Related Party Transactions by the Shareholders:

The requirement of shareholder approval for significant related party transactions is recommended to enhance the market discipline and to strengthen the equity culture.¹⁸ The reason is that shareholders are persons who lose from managerial opportunism. Outside directors are disinterested, whereas shareholders are positively interested in preserving corporate value. Therefore it is necessary that the meeting of shareholders should approve conflicted transactions.¹⁹

But the opposite view is that by delegating this power to the board the cost will be reduced and the collective actions problem associated with direct governance with the shareholders will also be avoided. Unless shareholders have large holdings or are few in number, they are unlikely to have the interest or the expertise to screen conflicted transactions. In addition, attempting to educate dispersed shareholders about these transactions is likely to put large cost on the company from the outset.²⁰

All over the world some countries follow this strategy, while in other countries there is requirement of approving these transactions by board of directors.

In U.K traditionally conflicted transactions with directors required shareholders consent,²¹ but nowadays according to the Companies Act, this rule is mandatory only for significant

¹⁸ Organization for Economic Co-operation and Development, *Corporate Governance in Turkey a Pilot Study*, (OECD publishing, 2006),101.

¹⁹ Reinier Kaarkman, Henry Hansmann, Gerard Hertig, *The Anatomy Of Corporate Law w: A Comparative and Functional Approach* (Oxford University Press, 2004), 109.

²⁰ Ibid, 110.

²¹ Ibid.

transactions. These transactions included directors long term services contracts,²² substantial property transactions,²³ and in listed companies shareholders approval is required for directors' remuneration.²⁴ There are many cases on the issue requiring the share holder approval for substantial transactions.

Re Duckwari plc (1999)2BCLC315 (Court of Appeal)²⁵

In this case Mr. Cooper was a director of Offerventure Ltd and also of Duckwari plc. Offerventure Ltd Company had contracted to buy a property in High Wycombe for development for 495.000 pounds, a fair price. Cooper offer to pass on the property to Duckwari at cost, on terms that he would receive a fifty percent share of any profits resulting from the development.²⁶ This offer was accepted by the board of directors of Duckwari but not approved by its members however approval of this transaction by shareholders was necessary because it was substantial money transaction. This was also a conflicted transaction in term that director had an interest in that transaction. After Duckwari had bought the property, there was a fall in the market and the property was ultimately sold for 177,970 Pounds and caused a big loss to Duckwari Company.

²² See, Section 188 of Companies Act 2006 of UK

²³ See, Section 190 of Companies Act 2006 of UK.

²⁴ Reinier Kaarkman, Henry Hansmann, Gerard Hertig, *The Anatomy Of Corporate Law w: A Comparative and Functional Approach*(Oxford University Press, 2004),110.

²⁵ Len Sealy, Sarah Worthington, *Cases and Materials in Company Law* (Oxford University Press, 2008, eight edition), 356.

²⁶ Ibid.

The court of appeal held that Cooper, Duckwari's other directors and Offerventure, as an associated company, were liable under Companies Act 1985 s.320-322 to indemnify Duckwari for the whole of its loss, including that due to the fall in the market values, and not simply for the difference between the price paid for the property and its value at the time of the transaction.²⁷

French Law requires that all self dealing transactions that are not taken in the ordinary course of business and reflect market conditions should be approved by the shareholders as well as by the disinterested board members.²⁸

By contrast other jurisdictions are less insistent on shareholder approval. In Germany, Japan and U.S, there is no mandatory requirement of shareholders approval for traditional self dealing transactions. In these jurisdictions shareholder approval is required only for some forms of managerial compensation.²⁹

2.2 Review by the Audit Committee:

It has become a common practice for boards to formulate board committees with the aim to facilitate the fulfillment of certain of the board's functions and deal with some potential conflicts of interest. The use of board committees is beneficial to enhance independent

²⁷ Ibid.

²⁸ Reinier Kaarkman, Henry Hansmann, Gerard Hertig, *The Anatomy Of Corporate Law w: A Comparative and Functional Approach* (Oxford University Press, 2004), 110.

²⁹ Ibid, 110.

judgment on matters in which there is potential for conflict of interest.³⁰ This approach is used mostly in countries where related party transactions are subject to approval by the board of directors.³¹

As the audit committee oversees, corporate governance, internal control, and audit function therefore its members are required to be financially literate, professionally qualified, and functionally independent.³²

This regulatory approach has worked more effectively in those countries where companies generally have been able to engage sufficient knowledgeable, experienced and significant independent board members,³³ and such individuals actively exercise such an oversight function and in addition there is effective mechanism to hold the board accountable for inadequate performance of this function.³⁴

In US according to the NASDAQ standards, all related party transactions for potential conflict of interest situations are required to be review and approved by an audit committee or another independent body of the board of directors.³⁵

³⁰ Supachai Panitchpakdi, *Guidance on good practices in Corporate Governance Disclosure* (United Nation Conference on trade and development),(United Nation –New York and Geneva,2006),15, http://www.unctad.org/en/docs/iteteb20063_en.pdf (accessed July, 30, 08).

³¹ Zabihollah Rezaee, *High quality financial reporting: the six legged stool*, (feb,2004), 02, www.allbusiness.com/finance/3591520-1.html (accessed Aug, 03, 2009).

³² Ibid.

³³ Organization for Economic Co-operation and Development, *Corporate Governance in Turkey a Pilot Study*,(OECD publishing,2006),101.

³⁴ Ibid.

³⁵ See, NASDAQ Standards, Rule 4350(h), http://www.complinet.com/file_store/pdf/rulebooks/NASDAQ_SR-NASDAQ-2007-022.pdf (accessed Aug, 03, 09).

In Pakistan there is also a requirement of reviewing related party transactions by the audit committee.³⁶

2.3 Disclosure of Related Party Transaction:

As Financial Accounting Standard Board statement 57 of USA describes related party transactions as one of the important areas involving high fraud risk.³⁷ American Institute of Certified Public Accountants also describes Related Party Transactions as a mechanism used by major shareholders and management for the purpose of making fraudulent financial statement by overstating income and by providing erroneous financial results to market participants.³⁸ Therefore transparency in such transactions is needed.

For attaining transparency in related party transactions disclosure is necessary and all these transactions need to be disclosed in the financial statement of the company as related party transactions. When these transactions have been motivated by fraud in such case these transactions are either not disclose in the financial statement or misstated in the financial statement of the company.

³⁶ See, Listing Regulation no. 38(7) Transfer Pricing of Karachi Stock Exchange as amended upto 2007.

³⁷ Muhammad Zakir Hussain Sharkar, Md Abdus Subhan, Shahida Sultana, "Association between corporate governance and related party transactions: A case study of banking sector of Bangladesh" *BRAC University Journal*, vol. 4, no.1(2007),32.

³⁸ Ibid.

Adelphia Communications Corporation ("Adelphia")³⁹

Adelphia is one of the oldest television network companies of the USA, engaged in numerous undisclosed related-party transactions with board members, executive officers, and entities they controlled. These transactions resulted in the transferring of company funds and stock into entities controlled by senior management. Adelphia failed to disclose the existence of these transactions or misrepresented their terms in its financial statements. Over \$300 million of company funds were abstracted to senior management without adequate disclosure to investors. Consequently on June 25, 2002, the company and certain of its subsidiaries filed for bankruptcy.

Therefore to remove or reduce the chances of fraud in related party transactions and to protect the company from loss full disclosure of such transactions is necessary. Such requirements indicate a regulatory view that related party transactions are relevant to decision making by financial statement users. This relevance is predicted on the view that certain relationships between the contracting parties create the opportunity for other than arms-length transactions terms.⁴⁰ Almost every country has made the disclosure requirement of such transactions in the laws of their country for attaining transparency and to increase the confidence of the public.

³⁹ PCAOB, *Standing Advisory Group Meeting on RELATED PARTY TRANSACTIONS* (Sep-8,9-2004), www.pcaobus.org. (accessed Aug, 06, 2008).

⁴⁰ Elizabeth A. Gordon, Elaine Henry, Darius Palia, *Related Party Transactions: Association with Corporate Governance and Firm Value* (sep-2004),10, <http://www.nd.edu/~carecob/Workshops/Gordon.pdf> (accessed Aug, 06, 2008).

On disclosure requirements, greater conformance with international accounting standard is suggested. Improved quality reporting to the shareholders in the form of annual reports and reports of related party transactions as reviewed by external auditors appear obvious as universal best exercise to avoid abusive related party transactions but not extensively practiced.⁴¹

Every payment to an employee or manager including salary, expense reimbursement, and equity based compensation is a related party transaction in which party is related to the company through employment,⁴² but these are the transactions in the ordinary course of business. Under the laws of USA only material transactions outside the ordinary course of business need to be disclosed because in such transactions shareholders interest may be particularly at risk of being treated with lower priority than the manager private interest.⁴³

In Pakistan according to Code of Corporate Governance every company is required to maintain a record of each related party transactions, in each financial year, along with all such documents and explanations.⁴⁴ Whereas under Schedule forth of Companies Ordinance, 1984 it is mentioned that the directors of the company will approved the accounting policy and transfer pricing for related party transactions and which shall be disclosed in the

⁴¹ Black et al,(report to the ministry of justice on proposed reforms to the commercial code of Korea (n.d.),02,

<http://www.secp.gov.pk/rc/CorpGovIntTrends/korea.pdf> (accessed July, 06, 2008).

⁴² Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of related party transactions in fraudulent financial reporting* (dec-2006), 05,

http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed 18 July 2008).

⁴³ Ibid.

⁴⁴ See Code Of Corporate Governance2002 of Pakistan,(xiiia-5).

financial statement of the company to identify that all transactions between the company and a related party are at arm's length price.⁴⁵

At International level there is current trend towards the enhanced disclosure of these transactions. Such disclosure should be provided despite of fact that whether the related party is treated differently from other share holders. Enhanced disclosure requirements include, the decision making process leading to the related party transaction, interest of the related party in the companies, their involvement in the transaction and in the decision making for such transaction, and special benefits flowing to them as a result of such transaction.⁴⁶

Almost all the countries have follow this practice, but in some countries rules regarding the disclosure of related party transactions are more stringent and in some countries these are not so.

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2.4 Auditing of Related Party Transactions:

As reliable and transparent financial reporting is particularly more important in the present situation.⁴⁷ Therefore, the purpose of auditing is to make the financial statement more reliable and to check any misrepresentation or misstatement in the financial statements.

⁴⁵ See, Part 1of Schedule Forth Companies Ordinance, 1984.

⁴⁶ Organization for Economic Co-operation and Development, *Corporate Governance in Turkey a Pilot Study*,(OECD publishing,2006),101.

⁴⁷ *Accounting and Auditing for Related Parties and Related Party Transactions*,

So auditing of related party transaction is necessary as the interest of company and that of shareholders is likely to more involve in these transactions. With regard to related party transactions auditing is a check that these transactions have been properly disclosed in the financial statement or not. Accounting and Auditing of related party transactions is inherently difficult.⁴⁸

Firstly because transactions with related party are not easily identifiable in the financial statement of a company. This is especially true where a company typically transacts with several small, private enterprises, the ultimate ownership of which cannot always be determined. The situation becomes more complex when the trading partner is based overseas.⁴⁹

Second, auditors rely on management and principal owners to identify all related parties and related-party transactions. However this becomes practically ineffective when the company insider engaged in a questionable transaction with a related party and to avoid being detected, he or she can simply not disclose the relationship. In general, auditors assume that related-party deals are made under the normal course of business until proven otherwise.⁵⁰

A Toolkit for Accountants and Auditors (Prepared by the staff of the American Institute of Certified Public Accountants), 31,
<http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 18, 2008).

⁴⁸ Related party transactions: cautionary tales for investors in Asia.(Report prepared by Asia Pacific office of the CFA Institute Centre For Financial Market Integrity, Jan,09), 36.

<http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1?cookieSet=1> (accessed Aug, 03, 2009).

⁴⁹ Ibid.

⁵⁰ Ibid.

Third, such transactions may not be easily tracked by a company's internal control.⁵¹ Therefore, for auditing RPT specific procedure should be made which should be followed by the auditor while auditing the related party transactions. The existence of some of the related parties is obvious such as parent- subsidiary, investor- investee and affiliates is obvious, however to determine the existence of other related parties specific audit procedure is necessary.⁵²

The purpose of auditing procedure designed specifically for related party transaction is to determine firstly the existence of related party transactions and secondly to identify significant related party transaction, including those not recognized in the auditing records.⁵³

After identifying the significant related party transaction, the auditor is required to examine these transactions and assess the sufficiency of their disclosure and should determine the purpose, nature and extent of these transactions. Auditor is also required to access the effect of these transactions on the financial statement.⁵⁴

⁵¹ Ibid.

⁵² *Accounting and Auditing for Related Parties and Related Party Transactions*, A Toolkit for Accountants and Auditors (Prepared by the staff of the American Institute of Certified Public Accountants), 25,

<http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 18, 2008).

⁵³ Micheal J. Ramos. *Wiley Practitioner's Guide to GAAS 2006* (John Wiley And Sons,2006), 243.

⁵⁴ Ibid.

At international level Standards on Auditing 'ISA' have also been formulated by the International Auditing and Assurance Board 'IAASB'.⁵⁵ International Auditing Standard 'ISA 550' provides the guidelines for the auditor while auditing related party transactions.⁵⁶ The objective of which is to obtain adequate audit evidence that related party relationship and transactions have been properly accounted for and disclosed in the financial statement and are in accordance with the related party requirements of the applicable financial reporting framework.⁵⁷

In USA, American institute of certified public accountants 'AICPA' statement of auditing standard(SAS) no. 45,AU Sec 334(2001) has provide a practicable approach for identifying material transactions,⁵⁸ which auditor has to follow while auditing related party transactions. In addition in 2001 the AICPA also developed a toolkit approach a sort of guideline, in which the detailed procedure for auditing of related party transaction is given.⁵⁹

⁵⁵ The International Auditing and Assurance Standards Board (IAASB), an independent standard setting body within the International Federation of Accountants (IFAC). Its office is located in the New York.

⁵⁶ International Auditing And Assurance Board, *proposed, revised and redrafted international standard on auditing: ISA 550*, (feb,2007),18

<http://www.iasplus.com/ifac/0703edisa550.pdf> (accessed, Aug,21,2009).

⁵⁷ AICPA, *Proposed Internatioal Standards on Auditing 550(revised):Related parties*, (jan 9,2007),04, http://www.aicpa.org/download/auditstd/2007_01_agenda_material/2007_01_ASBAgendaItem_5A-Revised_ISA_550.pdf (accessed July12, 2008).

⁵⁸ Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda* (n.d.), 231, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July12, 2008).

⁵⁹ See e.g., *Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors* (Prepared by the staff of the American Institute of Certified Public Accountants), <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 18, 2008).

2.5 Enhanced Penalties:

Strict penalties should be imposed on the persons who charged with the preparation of financial statement and they do not fulfill their obligation of making correct financial statement which represents the actual transactions of the company including related party transactions and actual financial position of the company. Abuse of related party transactions can be avoided to large extent by imposing strict penalties, as it will deter them from hiding the related party transactions from the financial statement.

By imposing penalties on false disclosure, a legal directive allows honest companies to distinguish themselves.⁶⁰ This strategy of imposing penalties is common in almost every jurisdiction but there is need to enhance it.

In addition to it in many jurisdictions penalties have also been imposed on the auditor in case of its failure to comply with the provisions relating to auditing, mention in the law of that jurisdiction, while audit the financial statements of the company.⁶¹ But with regard to related party transaction this strategy is useful in those jurisdictions where the specific procedure regarding auditing of related party transaction have been mentioned which is to be followed by the auditor while auditing such transactions.⁶²

⁶⁰ Joseph A. McCahery, *The Role of the Board in Related Party Transactions*, (NFCG Policy Dialogue on Corporate Governance in India, New Delhi February 16-17, 2006).
<http://www.oecd.org/dataoecd/51/34/37175408.pdf> (accessed Aug, 18, 2008).

⁶¹ See e.g., Section 105(c)(4) of Sarbanes Oxley Act 2002.

⁶² See e.g., Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda*, 231,

2.6 Conclusion:

All over the world almost every jurisdiction have made legal framework regarding related party transactions, most of which included to approve these transactions from the board of directors majority of whom should be independent. Then these transactions need to be reviewed by the audit committee which must comprise of independent directors and financially literate persons. So in other words it can be said that weak corporate governance lead to more abusive related party transactions, as number of directors on the board, approval requirement by the board, qualification of the members of the audit committee, all these things comes under the scope of corporate governance. In order to protect the company from the abuse of these transactions strong rules on corporate governance should be made. In addition by enhancing the penalties of making false financial statements and by enhancing the penalties of auditor in case of its failure to properly audit the financial statement, the chances of such abusive transactions can be mitigate to a large extent.

<http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July12, 2008).

CHAPTER 3

LEGISLATION IN OTHER JURISDICTIONS REGARDING RELATED PARTY TRANSACTIONS

3.1 LEGISLATION IN USA REGARDING RELATED PARTY TRANSACTION

3.1.1 Concept of Related Party and Related Party Transactions in USA:

In USA the definition of related party is mentioned in the FASB¹ Statement No. 57. According to which related party includes affiliates² of the venture, entities for which investments are accounted for, all sort of trusts³ and the members of the immediate families of principal owners of the corporation and that of its management⁴. It also includes the parties with which the corporation may deal if one party has the ability to exercise control on the other transacting party and may prevent that party from fully pursuing its own separate benefit, and the parties that have an ownership interest in one of the transacting parties and in this sense can influence that party.⁵

¹ Financial Accounting Standard Board of USA.

² An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

³ Such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.

⁴ American Institute of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors*, (Dec 2001), 08, <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

⁵ Ibid.

According to the New York Listing Manuals related party transactions means the transactions between the company and its officers, directors, and principal shareholders.⁶

3.1.2 The Extent of Related Party Transactions in USA:

Related party transactions are very common in USA. A large number of companies routinely report about these transactions. The Corporate Library, a governance research group, found that 75 percent of a subset of Dow Jones industrial average firms reported related party transactions⁷. It is also noted that, this rate is increased in the five years since 2001.⁸

3.1.3 Abusive Related Party Transactions in USA:

In USA, before the year 2002, the most common form of abusive related party transactions were giving loans to directors, and executive officers including Chief Finance Officer. In 2002 Sarbanes Oxley Act was promulgated in USA, which prohibited the personal loans to directors and executive officers by the company.⁹

⁶ Listing Manual 303A.01 of NYSE,
<http://nysemanual.nyse.com>.(accessed Aug 19, 2009).

⁷ Catherine M. Dalton et al., "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006),
<http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 06, 2008).

⁸ Ibid.

⁹ Section 402, Sarbanes Oxley Act 2002.

In USA abusive related party transactions were involved in the Parmalat case, and were main causes of the destruction of Adelphia Communications and WorldCom.¹⁰ Abusive related party transactions were also involved in Enron's scandal.¹¹ In fact the main factor involved in the collapse of the Enron's company was a series of related party transactions by which certain executives misrepresent the financial condition of the company.¹²

Case Law:

Enron Case:

Enron case of 2002 was one of the world's largest financial scandals involving related party transaction. In this case Enron used special purpose entities controlled by its Chief Finance Officer to manipulate income and transfer cash.¹³

In November 2001, Enron announced that it intended to restate its financial statements because of related-party transactions, among other things.¹⁴ A special committee was

¹⁰ Catherine M. Dalton et al., "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006), <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 06, 2008).

¹¹ See, e.g., Elaine Henry, Elizabeth A. Gordon, Tim Louwers, *Role of Related Party Transactions in Fraudulent Financial Reporting* (dec-2006),17, http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf (accessed July 18, 2008).

¹² See Catherine M. Dalton et al., "Related Party Transactions: Too Close for (Shareholder's) Comfort" *Journal of Business Strategy*, vol. 27,no.6(2006), <http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/2880270601.html> (accessed Aug 6,2008).

¹³ Mark Kohlbeck, Brian Mayhew , *Agency Costs, Contracting, and Related Party Transactions*, (December 2004),03 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592582 (accessed Aug, 16, 2009).

¹⁴ See, Enron case quoted in, PCAOB, *Standing Advisory Group Meeting on RELATED PARTY TRANSACTIONS* (Sep-8,9-2004), <http://www.pcaobus.org> .(accessed Aug, 06, 2008).

formulated by the Enron's Board of Directors in order to review transactions between Enron and its related parties.¹⁵

On February 1, 2002, Enron's Special Investigation Committee issued its findings in its "Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp."¹⁶ This Report stated that "Enron, like all public companies, was required to disclose its related-party transactions to its shareholders and to the members of the investing public in several different disclosure documents as prescribed by the federal securities laws, and was also required to disclose them in its quarterly and annual reports filed with the Securities and Exchange Commission."¹⁷ But significant issues concerning Enron's public disclosures of related-party transactions were found by the committee. Consequently, in December 2001, Enron, filed for bankruptcy.¹⁸

Parmalat Case:

Parmalat an Italian dairy-foods provider was initially a family-owned company which was converted into a public one in 1990. Its structure was typical of the Italian market as a whole.¹⁹ In this case abusive related party transactions were involved which were not

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ See, Parmalat case quoted in, Lee Swee Seng , *Director's Commitment To Enhance Transparency In A Business*,(n.d), <http://www.leesweeseng.com/acca.ppt> (accessed Aug, 06, 2008)

properly disclosed. The company Parmalat failed due to the improper disclosure of executive and director compensation and directors and officers' stock ownership, coupled with non disclosure of progressive practices.²⁰ In this case it was discovered that managers simply invented assets to offset as much as \$16.2 billion in liabilities and falsified accounts over a 15-year period. Consequently company went into bankruptcy on 27 Dec 2003.²¹

After these big scandals rules and regulations were enhanced in USA. A new Act known as Sarbanes Oxley Act was promulgated in 2002. Amendments were made in the existing laws.²² Public Company Accounting Oversight Board was established.²³ Further a tool kit was also issued by American Institute of Certified Public Accountants as guidance for the accountants and auditors.²⁴

3.1.4 Approval of Related Party Transactions:

3.1.4 (i) Approval of Related Party Transactions under US Company law:

Although the US does not have a national company law, each of the fifty states has its own law but to some extent it can be said that company law of a small state, Delaware, is the

²⁰ Ibid.

²¹ Ibid.

²² See, e.g., Paul, Weiss, *SEC Adopt New Executive Compensation And Related Party Disclosure Rules* (Aug 17 2006), 11,

www.paulweiss.com (accessed July, 18, 2008).

²³ See s.101 of Sarbanes Oxley Act 2002.

²⁴ See American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transactions ,A Toolkit for Accountants and Auditors*, (Dec 2001), <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

national corporate law.²⁵ Almost 60 percent of the fortune 500 corporations are registered in Delaware.²⁶

According to Delaware Corporation Act, where a company contracts with any of its director or officers or a partnership, or with any association or organization in which such director or officer is a director or officer, in which such director or officer has any interest, he shall disclosed his interest in the said contract before the Board or committee which authorizes the said contract.²⁷

It is also mention in it that where the said director or officer has disclosed his interest in the contract and the board or committee in good faith authorizes that contract by the votes of majority of the disinterested directors then such a contract shall not be void or void able, exclusively due to the reason that interested director or officer was also present or participate in the discussion at the meeting of the Board, which authorizes that contract or his vote was counted for this purpose.²⁸

This provision of Delaware Corporation Act that interested director can participate in the Board meeting and his vote can be counted regarding the contract in which such director is

²⁵ Reinier Kraakman Danang, *Legal Institutions and Economic Development*, (Nov,01,2002), [http://www.fetp.edu.vn/shortcourse/0102/eco_management/English/2-Fri-Jan11/3-Kraakman Corporate%20Law.pps](http://www.fetp.edu.vn/shortcourse/0102/eco_management/English/2-Fri-Jan11/3-Kraakman%20Corporate%20Law.pps) (accessed Aug, 20, 2008).

²⁶ Stephen M. Bainbridge, *Why The North Dakota Publicly Traded Corporations Act Will Fail*, (n.d),03, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364402 (accessed Aug 20, 2009).

²⁷ Section 144, Title 8, Delaware Corporation Act. <http://delcode.delaware.gov/title8/c001/sc04/index.shtml> (accessed Aug 20, 2009).

²⁸ Ibid.

interested is contrary to the international practice. In other jurisdictions like UK, India and Pakistan the general rule is that the interested director cannot participate in the meeting of the Directors deciding about contract in which such director is interested.²⁹ The provision that interested director cannot participate is necessary to show the transparency in such contracts, otherwise there might be an apprehension that such a contract might not be in the best interest of the company.

3.1.4 (ii) Approval requirement under the Listing Regulations:

As the shareholders can be affected by some related party transactions,³⁰ which are significant, therefore under the listing regulations of New York Stock Exchange some situations have been mentioned which required the approval of such transactions by the majority of share holders.³¹

Shareholder approval is required in the following situations:

a) where common stock issued to a related party and its total amount exceeds either 1% of the number of common stock or 1% of the voting power, in such situation approval of the shareholders is required before issuance.³²

²⁹ See Section 300 companies Act 1956 of India and also see Section 216 Companies Ordinance, 1984 of Pakistan.

³⁰ Elizabeth A. Gordon, Elaine Henry, and Darius Palia, *Related Party Transactions: Association with Corporate Governance and Firm Value*(2004),33, <http://www.nd.edu/~carecob/Workshops/Gordon.pdf> (accessed Aug 6, 2008).

³¹ Section 312.02(c) Listed Company Manual of NYSE. <http://nysemanual.nyse.com> (accessed Aug, 19, 2009).

³² Prof. Lim, *Defining, Disclosing And Discouraging Related Party Transactions* ,(Nov 11,2002),7, <http://www.oecd.org/dataoecd/49/9/2484893.pdf> (accessed July 26, 2008).

b) shareholders approval is also required before the issuance of common stock, or of securities convertible into or exercisable for common stock, to a related party if the common stock has equal to or greater than 20% of the voting power outstanding before the issuance.

c) shareholder approval is also required before any such issuance that will result in a change of control of the issuer.³³

However, share holders approval is not required in any public offering for cash and in any bona fide private financing if such financing involves a sale of common stock for cash at a price greater than the book and market value of the issuer's common stock.³⁴

3.1.5 Review by the Audit Committee:

Listing manuals of the NYSE requires that every company must have an audit committee.³⁵ In USA the requirements regarding composition of Audit Committee is that it must comprise of minimum three and maximum six members of the board of directors.³⁶ The requirement for members of audit committee is that they must be financially literate.³⁷ In US it is also mandatory for each member of the Audit Committee to be independent, that is, he is not

³³ Ibid, 8.

³⁴ Section 312.02(c) Listed Company Manual of NYSE.
<http://nysemanual.nyse.com> (accessed Aug, 19, 2009).

³⁵Section 303A.06 Listing manual of NYSE.
<http://nysemanuals.nyse.com> (accessed Aug, 19, 2009).

³⁶ See The Institute of Internal Auditors USA , *Sample Audit Committee Charter*
<http://www.theiia.org/guidance/standards-and-practices/additional-resources/audit-committees-board-of-directors/sample-audit-committee-charter/> (accessed July 15, 2008).

³⁷ Ibid.

accepting any advisory, or consulting, or other compensatory fee from the company, other than in his capacity as a member of the Committee.³⁸

In the listing manuals of the New York stock exchange there is requirement of review and oversight of these transactions by the audit committee or by any other independent body.³⁹

A similar requirement is also mentioned in the NASDAQ Standards. According to which appropriate review for all related party transactions for potential conflict of interest situations and approval by an audit committee or another independent body of the board of directors of such transactions is required.⁴⁰

The requirement regarding the review of related party transactions is very useful in detecting any misrepresentation regarding these transactions and it becomes more useful in situation where the members who review them are independent and financial literate. The requirement in USA regarding review of related party transactions by an independent audit committee is best in this regard as the audit committee consists of independent members who are also financial experts and can give better judgment with regard to these transactions.

³⁸ See Sec. 301 Sarbanes-Oxley Act of 2002.

³⁹ See section 307.00 listing manuals of the NYSE, <http://nysemanuals.nyse.com> (accessed Aug, 19, 2009).

⁴⁰ See, Rule 4350(h) NASDAQ Standards, http://www.complinet.com/file_store/pdf/rulebooks/NASDAQ_SR-NASDAQ-2007-022.pdf (accessed Aug, 03, 09).

In USA for the purpose of making transparency in related party transactions, enhanced disclosure requirements have been made, because whenever these transactions have been motivated by fraud in such situations these transactions are not disclosed in the financial statement.

3.1.6 Disclosure of Related Party Transactions:

3.1.6(i) Disclosure requirements under SEC Regulations:

In USA, public companies file their financial statements quarterly and annually with Security and Exchange Commission 'SEC'. As under the securities exchange Act 1934 it is mentioned that every issuer of a security which is registered under this Act shall file with the Commission such annual and quarterly reports as prescribed by the Commission from time to time.⁴¹

SEC regulations form S-K (item404) requires disclosure of certain relationship and related transactions while filing documents with Security and Exchange Commission.⁴² In 2006 the SEC has also adopted amendments to Item 404 of Regulation S-K in order to make an efficient system for disclosure of related party transactions.⁴³

⁴¹ See Section 12 Securities Exchange Act 1934.

⁴² See American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transactions ,A Toolkit for Accountants and Auditors*, (Dec 2001), 08, <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf>(accessed July 12, 2008).

⁴³ See e.g., Paul, Weiss, *SEC Adopt New Executive Compensation And Related Party Disclosure Rules*, (Aug 17 2006), 11, www.paulweiss.com (accessed July 18, 2008).

Item 404(a) introduced a general disclosure requirement for related party transactions, including transactions involving indebtedness. Item 404(a), as amended, requires disclosure of indebtedness of a related person if there is a direct or indirect material interest in a transaction exceeding \$120,000.⁴⁴

According to the Item 404(b) companies are required to disclose their policies and procedures for the review, approval, or ratification of related party transactions involving indebtedness.⁴⁵ It is also mentioned that such disclosure will also include the material features of these policies and procedures that are necessary to understand them.⁴⁶

Item 404(c) requires disclosure regarding promoters and certain controlling persons of the company. According to the amendments made in this item, companies that had promoters at any time during the last five fiscal years, are required to disclose each promoter's identity and the complete detail of the transactions with them.⁴⁷

In USA the companies, in addition to make disclosure in their financial statements, are also required to file with the SEC certain forms which also contain disclosure requirements regarding related party transactions. This shows that in USA extensive disclosure system

⁴⁴ Bradley T. Kamlet, *SEC Adopts Amendments to Disclosure of Related-Person Transactions and Other Corporate Governance Matters*, (08,23,06).

<http://www.sec.gov/divisions/corpfin/guidance/execcomp404interp.htm> (accessed Aug, 20, 2009).

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

regarding related party transactions has been established which certainly decreased the chances of hiding these transactions from the financial statements.

3.1.6(ii) Disclosure under the accounting rules (FAS Statements):

In the USA, the Financial Accounting Standard Board, FASB Statement No. 57, deals with related party disclosures and prescribes the requirements regarding disclosure of transactions with related parties.⁴⁸

FASB Statement No. 57 states that financial statements must include disclosures of material related party transactions.⁴⁹ According to which disclosures must include the nature of the relationships, the dollar amounts of the transactions, description of the transactions, and the amount due from or to related parties and the terms and method of settlement.⁵⁰ It also includes any other information that is essential to understand the effects of such transactions on the financial statements.⁵¹ According to this statement, related party transactions where no prices are charged are also required to disclose fully.⁵²

⁴⁸ Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*, (Sep 9, 2004), 04, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf (accessed July 20, 2008).

⁴⁹ See American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transactions ,A Toolkit for Accountants and Auditors*, (Dec 2001), 08, <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

⁵⁰ Ibid.

⁵¹ Ibid, 8.

⁵² Ibid.

3.1.6(iii) Disclosure requirement under the Listing Regulations:

Listing regulations of a stock exchange are the source of quasi legislations which also contains the regulations for related party transactions. New York Stock Exchange (NYSE), Listed Company Manual Section 307, also contains requirements regarding related party disclosure.⁵³ According to which there should be enhanced disclosure of related party transactions in the company's annual report and proxy statements as well as in other corporate filings.⁵⁴

According to the listing manual of the NYSE:

“The Exchange will continue to review proxy statements and other SEC filings disclosing related party transactions and where such situations continue year after year, the Exchange will directed the listed company, on a continuing basis, to evaluate each related party transaction and determine whether or not it should be permitted to continue.”⁵⁵

The requirements that the stock exchange will review the proxy statements and other SEC fillings disclosing related party transactions show that the exchange also keep a check on companies in this regard. The requirement that exchange will not only review the disclosure of these transactions but also gives directions to the companies to continue such transactions any more or not, further helps to mitigate the chances of abusive related party transactions.

⁵³ See section 307, Listing Manuals of NYSE
<http://www.nysemanual.nyse.com> (accessed Aug 20, 2009).

⁵⁴ John K M Lim, “Defining, Disclosing And Discouraging Related Party Transactions (RPT)”(papers presented at The Fourth Asia Roundtable on Corporate Governance, Mumbai, India, 11–13 November 2002), <http://www.oecd.org> (accessed July 26, 2008).

⁵⁵ Section 314.00, Listing Manual of NYSE.
<http://www.nysemanual.nyse.com> (accessed Aug 20, 2009).

The role of New York Stock Exchange is more active and powerful in this regard than any other exchange in the world.

3.1.7 Auditing of Related Party Transactions:

The past several years have shown that in USA there was an increase use of undisclosed related parties for the purpose of fraudulent financial reporting and misappropriation of assets.⁵⁶ As auditing is the process by which accuracy of financial statements is checked, in USA now external auditing is to be performed by registered public accounting firm. According to the Sarbanes Oxley Act the accounting firm performing the auditing of any company must be registered with the PCAOB.⁵⁷

In USA special procedure has been provided which is to be followed by independent auditor while auditing related party transactions. American Institute of Certified Public Accountants, Statement of Auditing Standard (SAS) No. 45, has supplied a practical approach for identifying material transactions.⁵⁸ The SAS No. 45 deals with auditing of related party transaction. The procedure prescribed in this statement includes the following steps which are briefly discussed here.

⁵⁶ Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*, (Sep 9, 2004), 01, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf (accessed July 20, 2008).

⁵⁷ Section 102(a), Sarbanes Oxley Act 2002.

⁵⁸ Joseph A McCahery and Erik P.M. Vermeulen, *Corporate governance crises and related party transactions: A post Parmalat agenda*, (n.d.), 231, <http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf> (accessed July 12, 2008).

(i) Determining the existence of Related Parties:

Although certain relationships may be clearly evident such as parent-subsidary, investor-investee but other may not be so obvious.⁵⁹ SAS No.45 provides a detailed procedure which should be followed by the auditor for determining the existence of other related parties from the financial statement, the relationship of whom are not so evident.⁶⁰

(ii) Identifying Transactions with Related Parties:

SAS No.45 not only provide guidance for identifying material transactions with known related parties but also supply guidance for identifying material transactions that may be indicative of the existence of undetermined relationships.⁶¹ According to which the auditor should in order to get information regarding material related party transactions, review the minutes of meetings of the board of directors and executive or operating committees, proxy and other material filed with the Securities and Exchange Commission (SEC).⁶² Auditor is also required to review prior year's working papers for the name of known related parties.⁶³ In order to get complete information auditor should also review accounting records

⁵⁹ Ibid.

⁶⁰ Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*, (Sep 9,2004),16, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf (accessed July 20, 2008).

⁶¹ See American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transaction: A Toolkit for Accountants and Auditors*, (Dec 2001), 26, <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

⁶² Ibid.

⁶³ Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*, (Sep 9,2004),16,

for large, unusual, or nonrecurring transactions.⁶⁴ By reviewing these entire material auditor will be in better position to identify the transactions with undisclosed relationships.

(iii) Examining the identified Related Party Transactions:

According to SAS No. 45 auditor should examine the identifying related-party transactions by applying specific procedures in order to obtain satisfaction regarding the purpose, nature, and extent of these transactions and to see their effect on the financial statements.⁶⁵ It is also mentioned in the statement that for this purpose auditor should examine the invoices, executed copies of the agreement, contracts and other pertinent documents and determine whether the transaction have been approved by the director or other appropriate officials.⁶⁶ Auditor is also required to obtain satisfaction concerning the transferability and value of the security.⁶⁷

It is also mentioned that the procedure should be directed toward obtaining and evaluating sufficient evidential matter and should extend beyond just inquiry of management.⁶⁸

http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf (accessed July 20, 2008).

⁶⁴ See, American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transaction: A Toolkit for Accountants and Auditors*, (Dec 2001), 26, <http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

⁶⁵ Public Company Accounting Oversight Board, *Standing Advisory Group Meeting on related party transactions*, (Sep 9, 2004), 16, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Related_Party_Transactions.pdf (accessed July 20, 2008).

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ American Institute Of Certified Public Accountants, *Accounting and Auditing for Related Parties and Related Party Transaction: A Toolkit for Accountants and Auditors*, (Dec 2001), 26,

(iv) Auditing Disclosures:

According to this statement after complete examination the auditor should then evaluate all information available regarding the related-party transaction or control relationship and verify that the related party transaction or control relationship is adequately disclosed in the financial statements.⁶⁹

As the auditing is performed to check the authenticity of financial statement, it is therefore prohibited in USA to influence the auditor while performing the auditing of financial statements of an issuer. According to the Sarbanes Oxley Act 2002 it is unlawful for any director or officer to take any action to fraudulently influence or mislead any independent public accountant performing the audit of financial statement of that issuer, in order to make such financial statements materially misleading.⁷⁰

In USA enhanced penalties have been prescribed under Sarbanes Oxley Act for the auditor in case the auditor fails to properly audit the financial statements of the company or fails to comply with any procedure prescribe by the SEC, while performing the auditing. According to which the Public Company Accounting Oversight Board may impose such disciplinary or remedial sanctions as it determines appropriate, which includes;

<http://thecaq.aicpa.org/NR/rdonlyres/91AC0AE8-6BD8-4593-91F0-E5A0F6AE59FA/0/AccountingandAuditingforRelatedPartiesToolkit.pdf> (accessed July 12, 2008).

⁶⁹ Ibid, 27.

⁷⁰ Section 303 (a), Sarbanes Oxley Act 2002.

- (A) Temporary or permanent suspension or permanent revocation of registration under this title;
- (B) Temporary or permanent bar of a person from further association with any public accounting firm or temporary or permanent limitation on the activities, functions or operation of such firm or person;
- (C) and censure or any other appropriate sanction provided for in the rules of the Board.⁷¹

Enhanced civil money penalty has also been mentioned in it, according to which the PCAOB may impose money penalty of an amount up to \$100,000 on auditor for each violation.⁷²

In USA procedure has been prescribed for auditor which auditor has to follow while auditing related party transactions. In addition strict penalties have also been prescribed for the auditor in case of their non compliance. In fact strict penalties deter the auditor from non compliance with the audit procedure necessary to detect the undisclosed related party transactions from the financial statements which in turn increase the credibility of the financial statements.

3.1.8 Independent Oversight of Auditing Profession:

In USA after the big scandals like Enron, Adelphia, Tyco the strategy of independent oversight of auditing profession was introduced in 2002 and for this purpose Public

⁷¹ Section 105(c), Sarbanes Oxley Act 2002.

⁷² Ibid.

Company Accounting Oversight Board 'PCAOB' was formed under Sarbanes Oxley Act 2002.⁷³ After the formation of PCAOB all the accounting firms performing the auditing of companies need to be registered with it.

According to the Sarbanes Oxley Act for performing the function of independent oversight, the PCAOB shall conduct a continuous program of inspection to assess the degree of compliance of each registered public accounting firm and their associated persons with this Act, the rules of the Board and SEC, or professional standards, while performing the audit.⁷⁴

PCAOB has also power to conduct investigation and disciplinary proceedings concerning, and to impose suitable sanctions where justified upon registered public accounting firm and persons associated with them.⁷⁵

This is a very good step taken by the USA to formulate independent oversight of the auditing profession. This helps them to keep check on auditors in performance of their duties and also on their compliance with audit standards which in turn increase the credibility of audit profession.

⁷³ See Section 101, Sarbanes Oxley Act 2002.

⁷⁴ Section 104(a), Sarbanes Oxley Act 2002.

⁷⁵ See, section 101, Sarbanes Oxley Act 2002.

3.2 LEGISLATION IN INDIA REGARDING RELATED PARTY TRANSACTIONS

3.2.1 The concept of Related Party in India:

As per the companies Act 1956, for the purpose of preparation and presentation of financial statements the parties considered as related parties are directors and their relatives, firm in which the director or his relative is a partner, or a private Limited Company in which a director is a member and subsidiaries and companies under the same management.⁷⁶

According to the Accounting Standard 18 issued by the Institute of Chartered Accountants of India 'ICAI'⁷⁷ of India related party includes companies that directly or indirectly control the other, individuals and their relatives having substantial voting power in the company, members of key management and their relatives,⁷⁸ associate companies, joint ventures, and investing parties of the reporting enterprise and also includes enterprises owned by directors, major shareholders, and also with common key management members.⁷⁹

⁷⁶ Anil Khicha, *D. Audit & Assurance - Related Party Transactions - You Need to know while conducting audit.* (n.d),
<http://articles.manupatra.com/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch>
(accessed Aug 24, 2009).

⁷⁷ ICAI is a statutory body established under the Chartered Accountants Act 1949 for the regulation of profession of chartered accountancy in India.

⁷⁸ Anil Khicha, *D. Audit & Assurance - Related Party Transactions - You Need to know while conducting audit.* (n.d),
<http://articles.manupatra.com/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch>
(accessed Aug 24, 2009).

⁷⁹ Ibid.

The types of persons included in the definition of related parties are almost similar in all jurisdictions hence in line with international standards.

3.2.2 Related Party Transactions in India:

In India almost 80 percent of the listed companies are family controlled business. These companies carry on their business through subsidiaries, associates. The transactions between these entities play very important role in analyzing the investment feasibility of an entity. If these transactions are unchecked, companies will use this opportunity for tax avoidance and deceive the investor.⁸⁰ These types of transactions are also common among directors entering into transactions with the companies and gain personal benefits. To avoid these types of transactions and to bring transparency, stringent provisions have been formulated.⁸¹

In India related party disclosures reveal that the transactions of loans between companies and their subsidiary companies and joint ventures are common. As the loans to them is not prohibited by the law.⁸² Under the section 295 of the Companies Act 1956 it is mentioned that no prior approval of the Central Government is required in case of any loan made by a

⁸⁰ Tax Guru, *Article on related party transactions and legal provisions*, (Jan 17, 2009).
<http://www.taxguru.in/company-law/article-on-related-party-transactions-legal-provisions.html>
(accessed Aug 17, 2009).

⁸¹ Ibid.

⁸² Aarati Krishnan, "Related party transactions: Companies tread a thin line" *Business Line* (Dec,08, 2002)(Hindu Group of publication).
<http://www.thehindubusinessline.com/iw/2002/12/08/stories/2002120800510600.htm>
(accessed July, 20, 2008).

holding company to its subsidiary, or any guarantee given or security provided by a holding company in respect of any loan made to its subsidiary.⁸³

Example:

In 2001-02, Reliance Industries in India extended loans of rupees 14,000 crore to associated companies. Before the end of the year rupees 12,833 crore was paid back, but the size of the transaction is still significant.⁸⁴

The rules and regulations in India regarding related party transactions are following.

3.2.3 Approval of Related Party Transactions:

3.2.3(i) Approval of related party transactions under Companies Act 1956:

In the Companies Act of India two situations, of transactions between a company and any of the related party, have been prescribed in which the prior approval by the central government is required.

⁸³ Section 295(2), Companies Act 1956.

⁸⁴ Aarati Krishnan, "Related party transactions: Companies tread a thin line" *Business Line* (Dec,08, 2002)(Hindu Group of publication)
<http://www.thehindubusinessline.com/iw/2002/12/08/stories/2002120800510600.htm> (accessed July, 20,08).

a. Approval by the Central Government:

(i) In India according to section 295 of the Companies Act of India 1956 a company cannot give any loan to its director nor can give any guarantee or provide any security for any loan made to a director by any person, or made by director to any other person without taking the prior approval of the central government in this behalf.⁸⁵

(ii) According to Companies Act 1956, where the company having a paid-up share capital of one crore or above, in such situation the company cannot enter into a contract for the sale purchase of goods or services with any of its director or his relative or the firm or private company in which such a director or his relative is a member or director without taking the prior approval of the central government.⁸⁶

b. Approval by the board of directors:

According to section 297 without taking the prior consent of the Board of Directors of the company, no director of the company or his relative, or any other company in which such director or any of his relative is a director or member can enter into contract for sale, purchase of goods, material or supply of services with the company.⁸⁷ It is also mentioned

⁸⁵ See Section 295, Companies Act 1956.

⁸⁶ See Section 297 (1)(b), Companies Act of 1956.

⁸⁷ See Section 297 (1)(a), Companies Act 1956.

under the Companies Act 1956 that no such consent is required if such sale, purchase is for cash at existing market prices.⁸⁸

The consent of the board of directors is also not required for contract of sale, purchase or transfer of any goods or services between the company and any of the director or his relative, or any other company in which such director or any of his relative is a director or member, where the price of the goods or material or services do not exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract or contracts.⁸⁹

It is also mentioned in the Companies Act 1956 that a contract in which director has any interest, he is required to disclose to the Board about the nature of his interest in that contract or arrangement. The disclosure is required to be made at the meeting of the board at which the question of entering into the contract or arrangement is first taken into consideration.⁹⁰

According to the Companies Act 1956, an interested director cannot participate in discussion or vote regarding the contract in which he has an interest and his presence will not count for the purpose of forming a quorum.⁹¹ It is also mentioned that every company will maintain a register of all contracts in which any of the directors has any interest.⁹²

⁸⁸ See Section 297 (2), Companies Act 1956.

⁸⁹ See Proviso of section 297(2), Companies Act 1956.

⁹⁰ Section 299, Companies Act 1956.

⁹¹ Section 300, Companies Act 1956.

⁹² Section 301, Companies Act 1956.

In India there is a requirement that board of directors should consists of fifty percent non-executive directors.⁹³ It is also mentioned in the listing regulation that where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.⁹⁴

c. Approval by Members:

In the Companies (Amendment) Act 2006 a provision has been inserted according to which prior approval of members in general meeting is required in case the Board provides a financial assistance to the members of the producer company by way of loan and advances against security specified in articles to any Member.⁹⁵

It is also mentioned that such loan will be repayable within a period exceeding three months but not exceeding seven years from the date of disbursement of such loan or advances.

3.2.3(ii) Approval of Related Party Transaction under the Listing Regulations:

Under the listing regulations only the procedure regarding the approval of fees and compensation to non executive director is prescribed which is also a form of related party transaction. According to which prior approval of shareholders is required for all fees and

⁹³ Listing regulations clause 49(I)(A) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

⁹⁴ Ibid.

⁹⁵ See Section 581ZK Companies Act 1956 (Amendment 2006).

compensation if any paid to non-executive directors, including independent directors which is fixed by the Board of Directors.⁹⁶

The shareholders' resolution in this regard shall specify the limits for the maximum number of stock options that can be granted to them, in any financial year and in aggregate.⁹⁷

As in India there is requirement to take the approval of related party transactions from the Board of directors so it seems necessary that the composition of Board must be strong enough to ensure that directors have taken the decision by exercising independent judgment. The requirement of independent directors on the Board of Indian companies, which is one third in case the chair man of the Board is non executive and fifty percent in case he is an executive director, is sufficient to make sure that Board is in position to make the decision without any influence which could be in the best interest of the company.

3.2.4 Review by the Audit Committee:

Mumbai Stock Exchange is the biggest stock exchange of the India. The listing regulation of the Mumbai stock Exchange assigns the role of reviewing related party transactions to the audit committee of the company.

⁹⁶ Listing regulation 49 (B) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

⁹⁷ Ibid.

According to the listing regulations of Mumbai stock exchange a statement in summary form of all related party transactions which are in the ordinary course of business shall be placed periodically before the audit committee.⁹⁸ It is also mentioned that details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.⁹⁹

Details of material individual transactions with related parties or others, which are not on an arm's length basis, should also be placed before the audit committee, together with Management's justification for the same.¹⁰⁰

According to the Listing Regulations the audit committee is not only required to review related party transactions but also to review, with the management, the annual financial statements before submission to the board for approval, with particular reference to disclosure of any related party transaction.¹⁰¹

As all the related party transactions, whether these are in normal course of business or not, are disclosed before the audit committee and reviewed by the audit committee, it means it necessarily comprises of some financial experts. In India according to the listing regulations of the Mumbai stock exchange there must be a qualified independent audit committee in

⁹⁸ Listing regulations 49 (IV)(A) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

⁹⁹ Ibid.

¹⁰⁰ Ibid.

¹⁰¹ See Listing regulations clause 49 (II)(D) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

each company which consists of minimum three directors as member.¹⁰² Two-thirds of the members of audit committee are required to be independent directors and the chairman of audit committee is also required to be an independent director.¹⁰³

Under the regulations of BSE the requirement regarding the members of audit committee is that they must be financially literate i.e. they shall have the ability to read and understand basic financial statements, and at least one member shall have accounting or related financial management expertise.¹⁰⁴

In India the audit committee considered to be necessary for every registered company and by an amendment in Companies Act 1956 the requirement of audit committee has been inserted.¹⁰⁵ According to which every company having a paid up share capital of more than five crore shall constitute an audit committee, which consist of at least three members two third of whom should be non executive directors.¹⁰⁶ The main function of the audit committee according to this section is to look and supervise the internal control system, audit, and reviewing the financial statements of the company.¹⁰⁷

¹⁰² See Listing regulations clause 49 (II)(A) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

¹⁰³ Ibid.

¹⁰⁴ Ibid.

¹⁰⁵ See section 292A, Companies Act 1956(amended Act 2006).

¹⁰⁶ Ibid.

¹⁰⁷ Ibid.

It is also mentioned that in case of non compliance with the provisions of this section the company shall be liable to imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both.¹⁰⁸

The responsibility of audit committee with regard to related party transaction is to review them. However the Audit committee can perform this function well only if it comprise of majority of independent and financial experts. The composition of audit committee of India is sufficient in this regard and is in line with international practice.

3.2.5 Disclosure of Related Party Transactions:

3.2.5(i) Disclosure under Accounting Standards:

India has formulated its accounting standards issued by the Institute of Chartered Accountants of India. The aim of setting standard is to bring the uniformity in financial reporting.¹⁰⁹ The standards are also considered necessary for the purpose of bringing uniformity and comparability in the data published by enterprises.¹¹⁰ In all thirty accounting standards have been prescribed.¹¹¹

¹⁰⁸ Section 292A(11), Companies Act 1956.

¹⁰⁹ Prof. V. K. Sapovadia, *Relevance, Issues and Importance of Accounting standards*.(n.d),11
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245962 (accessed Aug 24,2009).

¹¹⁰ Ibid.

¹¹¹ Ibid, 02.

Under the Companies Act 1956 it is mentioned that every company shall formulate its profit and loss account and balance sheet in compliance with these accounting standards.¹¹²

Accounting Standard (AS 18) relates to the disclosure of related party transactions. This standard provides for disclosure of related party relationships and certain particulars of transactions with the related parties, for the listed company and the companies whose turn over exceeds rupees fifty crore.¹¹³

According to this standard every company must disclose the name of the related party and nature of the relationship with the related party irrespective of the fact that there has been any transaction between the related party or not.¹¹⁴

It is also mentioned that if there have been transactions between the related parties, then the disclosure must include the name of the related party, details of the relationship, nature of the relationship, amount of the transaction, the amount outstanding, provisions for the doubtful debts, detail of the amount written off, the method adopted for pricing such transactions, and all other relevant details which considered necessary for understanding the financial

¹¹² Section 211(3A), Companies Act 1956.

¹¹³ K. R. Srivats, "ICAI relax norms on related party disclosure". *Business Line* (March 29, 2002). <http://www.thehindubusinessline.com/2002/03/29/stories/2002032900890500.htm> (accessed Aug 24, 2009).

¹¹⁴ Anil Khicha, *D. Audit & Assurance - Related Party Transactions - You Need to know while conducting audit.* (n.d), <http://articles.manupatra.com/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch> (accessed Aug 24, 2009).

statement.¹¹⁵ Proper disclosure is also necessary in case of non compliance to these requirements.¹¹⁶

The AS 18 also requires the disclosure of particulars in respect of certain types of related parties which have controlling interest even though no transaction with them had taken place during the course of the year.¹¹⁷ Listed companies are required to disclose the related party transactions in the quarterly and half yearly financial statements also.¹¹⁸

With the amendment of the Companies Act, 1956 through the Companies (amendment) Act, 1999, accounting standards have been given a statutory backing, or simply we can say by inserting them in the Act.¹¹⁹ In December 2006 the Central Government of India notified 28 Accounting Standards in the form of Companies (Accounting Standards) Rule, 2006.¹²⁰

3.2.5(ii) Disclosure under Listing Regulations:

According to the listing regulations of the Mumbai Stock Exchange the companies listed on the Mumbai stock exchange have to submit a quarterly compliance report to the exchange.¹²¹

¹¹⁵ Ibid.

¹¹⁶ Ibid.

¹¹⁷ Ibid.

¹¹⁸ Ibid.

¹¹⁹ Prof. V. K. Sapovadia, *Relevance, Issues and Importance of Accounting standards*.(n.d),12, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245962 (accessed Aug 24, 2009).

¹²⁰ Ibid.

¹²¹ See Listing regulations clause 49(VI) of Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

In the contents of this report disclosure of related party transactions also included, which shows that they follow the phenomenon of timely disclosure of related party transactions and also provide a format in which form disclosure should be made.¹²²

As disclosure of related party transactions is necessary to bring transparency in such transactions. In India Disclosure requirements regarding related party transaction have been mentioned in the listing regulations as well as in the accounting standards which are sufficient to bring the transparency in such transactions. Further the disclosure requirements mentioned in the standards are applicable not only on all listed companies but also on big unlisted companies, registered under the Companies Act, 1956 and for their best compliance a good step taken by Indian government by giving these standards statutory backing which mitigate the chances of their non compliance by the companies.

3.2.6 Auditing of Related Party Transactions:

India has also formulated standards on auditing to be known as accounting and auditing standards (AAS) issued by the Auditing Assurance Board of ICAI. These auditing standards correspond to some extent by the International Standards on Auditing.

¹²² See Annexure IB of clause 49 of the Rules, Bye-laws and Regulations of Bombay Stock Exchange Limited Mumbai 1957.

Accounting and Auditing Standard (AAS 23) relates to the related parties and provides a procedure which is to be followed by the auditor while auditing related party transactions. The procedure prescribed by the 'AAS 23' involves following steps.

(i) Identifying Related Party Transactions:

As some times related party transactions are not disclosed in the financial statement, therefore this standard provides a guideline for auditor for identifying these transactions.

According to which the auditor should review information provided by the directors and management identifying the names of all known related parties and should perform other procedures in respect of completeness of this information. Auditor is required to check the adequacy of control procedures over the authorisation and recording of related party transactions.¹²³

Auditor is required to have a level of knowledge of the entity's business and industry that will make possible the identification of the events, transactions and practices that may have a material impact on the financial statements.¹²⁴

¹²³ Accounting and Auditing Standards (AAS) issued by Institute of Chartered Accountants of India. http://www.caclubindia.com/forum/files/50_auditing%20and%20accounting%20standards.doc (accessed Aug 24, 2009).

¹²⁴ Ibid.

(ii) Examining the identified Related Party Transactions:

In examining the identified related party transactions, the auditor should obtain adequate audit evidence as to whether these transactions have been properly recorded and disclosed. Auditor should obtain a written representation from management that management have provided him complete information regarding identification of related parties and adequacy of related party disclosures in financial statements.¹²⁵

(iii) Auditing Disclosure:

After examining the identified related party transactions the auditor will disclose them in his report. If the auditor thinks that their disclosure in the financial statement is not sufficient, auditor needs to express a qualified opinion or a disclaimer of opinion in his audit report, as may be appropriate.¹²⁶

Satyam Case:

Satyam Computer system was India's fourth largest information technology company. Satyam was listed in India in 1991 and issued American Depository Receipts, or ADRs, on the New York Stock Exchange in 2001.¹²⁷ At least on paper, it complied with the strict international corporate-governance norms (including the Sarbanes-Oxley Act of 2002). The

¹²⁵ Ibid.

¹²⁶ Ibid.

¹²⁷ Salil Tripathi, "Restoring faith in Brand India". *Far Eastern Economic Review* (March 06, 2009).

<http://www.feer.com/essays/2009/march/restoring-faith-in-brand-india> (accessed Aug 24, 2009).

company having fifty three thousand employees, and was working in 66 countries. Its chief executive officer and founder, B Ramalinga Raju, twice received awards from Ernst & Young, and the Indian media lionized him.¹²⁸

In December 2008, the Chief Executive Officer of the company told to investors that the company would purchase two real estate companies controlled by his sons. This was a significant related party transaction, but was not sufficiently discussed as required by law at the board. Investors objected on it, and the deal was scrapped within a day.¹²⁹

After that the World Bank barred the Satyam from bidding for eight years because of allegations of possibly corrupt conduct.¹³⁰ Infact in this case abusive related party transactions were involved and financial statement did not disclose the true picture of company financial position. The balance sheets of the company significantly overstated the firm's cash reserves, whereas in fact a billion dollars were missing.

ICAI has now recently approved revised auditing standard of SA 550 which is in line with the International auditing Standard issued by the International Auditing Standard Board of International Federation of Accountants.¹³¹ SA 550 is aimed to strengthen current auditing practice in the area of related party transactions.¹³²

¹²⁸ Ibid.

¹²⁹ Ibid.

¹³⁰ Ibid.

¹³¹ Neha Pal, "ICAI has revised the norms after Satyam Fracas", *THE FINANCIAL EXPRESS* (Jan, 01, 2009).

As more risk attached to the related party transactions, this makes it necessary that procedural guidelines should be prescribed for auditor while auditing related party transactions. In India Auditing standards issued by the ICAI prescribed the procedure that should be followed by the auditor while auditing related party transactions but unlike USA there is no system of independent oversight of auditing to keep check on auditors regarding their compliance with these standards.

Auditor report:

Auditor after performing the audit of the financial statements of the company gives the report under section 227 of the Companies Act 1956. In 2003 a Companies Audit Report Order 2003 (CARO) was issued by the Central Government of India.¹³³ According to which auditor has to give statement in his report on the matters specified in it. Companies Auditors Report Order, 2003, requires specific observations of the auditor regarding related party transactions.¹³⁴ According to which auditor has give statement that either the company has taken or granted any loan to any director, his relative or to any company in which such director is officer or a director and if it is so he is also required to provide in his statement

<http://www.financialexpress.com/news/icai-revises-norms-after-satyam-fracas/405210/0> (accessed Aug 24, 2009).

¹³² Ibid.

¹³³ Companies Auditor Report Order(CARO 2003). Internet version,

<http://wirc-icai.org/refManual2009/Company%20Law/18-Caro.htm> (accessed Aug 24, 2009).

¹³⁴ Anil Khicha, *D. Audit & Assurance - Related Party Transactions - You Need to know while conducting audit.* (n.d),

<http://articles.manupatra.com/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch> (accessed Aug 24, 2009).

the amount of the transaction.¹³⁵ Auditor is also required to give statement that either the terms and conditions of the loan are prejudicial to the interest of the company, and where the amount overdue is more than one lac a statement is also required to be given to the effect that either company has taken reasonable steps for the recovery or payment of that amount.¹³⁶

The disclosure in audit report regarding related party transaction is a good step from the investor point of view. As investor generally rely on auditor report therefore making disclosure requirements of significant related party transactions in auditor report will certainly increase the investors, shareholders confidence on financial reporting of the company.

¹³⁵ Rajkumar S Adukia, Companies Auditor Report Order 2003(n.d),01, http://www.caclubindia.com/books/companies_auditors_report_order_2003/Annexure2.asp (accessed Ag 24, 2009).

¹³⁶ Ibid.

CHAPTER 4

LEGISLATION IN PAKISTAN REGARDING RELATED PARTY TRANSACTIONS

4.1 Concept of Related Party in Pakistan:

Initially, in Pakistan under the Companies Ordinance 1984 nowhere the specific definition of the related party is given.¹ Under section 195 it is mentioned that “relative” in relation to a director means the “spouse of directors and their minor children”². In 2003 SECP made an amendment by notification³ in the forth schedule of the Companies Ordinance 1984 and inserted the definition of a related party.⁴ According to which “related party”, in relation to a company, “means an entity which has the ability to control the company or exercise significant influence over the company in making financial and operating decisions or vice versa and includes the following, namely:⁵

- (a) entities that directly or indirectly control, or are controlled by the reporting company;
- (b) associates;
- (c) individuals having directly or indirectly, an interest in the voting power of the reporting company, and their family members and such entities in which such individuals or key

¹ See Companies Ordinance, 1984.

² See section 195 of Companies Ordinance, 1984

³ See SECP notification, S.R.O. 66(I)/2003, dated 22nd January, 2003.

<http://www.secp.gov.pk> (accessed July 12, 2008).

⁴ See schedule forth of Companies Ordinance, 1984 as amended upto 2005.

⁵ Ibid.

management personnel have substantial interest in the voting powers also include the entities owned by directors or major shareholders;⁶

(d) key management personnel, and their close families members; (e) entities in which one or more of the directors or members of the governing board are appointed by the reporting company or vice versa;

(e) where more than half of the raw materials and consumables required in the process of manufacture of an entity are supplied by the reporting company;

(f) where goods or articles manufactured or processed by an entity are sold or transferred to the reporting company and the prices and other conditions relating thereto are influenced by the entity or the company.”⁷

The types of persons included in the definition of related parties are almost similar in all jurisdictions hence in line with international standards.

4.2 Related Party Transactions in Pakistan:

In Pakistan corporations have been historically family controlled, and today still majority of the corporations are family controlled, but now the trend of changing the structure of family controlled corporations has emerged.⁸ The basic reason of changing the family controlled type of structure of companies in Pakistan is the increased awareness by many companies of

⁶ Ibid.

⁷ Ibid

⁸ Haroon H. Hamid and Valeria Kozhich, “Corporate governance in an emerging market: A perspective on Pakistan”, *Journal of Legal Technology Risk Management*, vol.1, no. 1(n.d.), 03, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976499. (accessed Sep 28, 2009).

the need of good governance.⁹ Related party transactions are common in business.¹⁰ As the family owned companies mostly transacts with their subsidiaries therefore related party transactions with the subsidiaries are also common especially of granting loan to them as are not prohibited by the Companies Ordinance 1984.¹¹ The risk attached to these transactions is high as chances of fraud in these transactions are high. There are some cases on it.

Taj Textile Enterprise case 2001:

This was a case of two associated undertakings namely Taj Textile and Elahi Enterprise. Both companies had some of directors in common. In this case abusive related party transaction in the form of loans was involved. A loan of amount 246.853 million was granted by the Elahi Enterprise Company to the Taj Textile Company. In the annual accounts of the company a note was mentioned that company had taken a short term borrowing from a private company without disclosing the relationship with the company. Auditor after auditing the financial statement and accounts of the company of the year ending September 30, 2000-2001 gave the unqualified report that the accounts of the company for the year present were fair.¹² The annual accounts of the company Taj Textile

⁹ Ibid.

¹⁰ Jacqueline Lam, Potential risk of Related Party Transactions and its impact on audit (July 2006). <http://www.pkf-hk.com/pdf/Audit/060720%20JL%20-%20Potential%20Risks%20of%20RPT.pdf> (Aug 24, 2009).

¹¹ See Section 214 of the Companies Ordinance, 1984.

¹² See, Order of the Securities and Exchange Commission of Pakistan, Enforcement Law Division,05, <http://www.secp.gov.pk/orders/pdf/Order030429A.pdf> (accessed, Aug 29, 2009).

along with directors and auditor report was sent by the company to the SECP under section 233 of the Companies Ordinance 1984.¹³

The Enforcement Law Division of the SECP found that the loan of amount 246.853 million was granted to Taj Textile by the Elahi Enterprise in the year 2000-2001. On further scrutiny it was found that it was material related party transaction but the fact that it was related party transaction was not disclosed in the financial statement, neither the relationship between both companies was disclosed. Auditor failed to comply with the International Standards on Auditing and in spite of giving a qualified report gave an unqualified report after auditing the financial statement. He failed to bring out the omission of said material facts about the affairs of the Taj Textile. His report was false in this regard.¹⁴

A show cause notice was given to the auditor and later on nominal money penalty of amount four thousand was imposed on the auditor by the Enforcement Law Division of the SECP.¹⁵

The rules and regulations in Pakistan in order to make related party transactions fair and to avoid the abuse of these transactions are following:

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Ibid, 62.

4.3 Approval of Related Party Transactions:

4.3.1 Approval of Related Party Transactions under Companies Ordinance 1984:

(i) Approval by the Commission:

According to the Companies Ordinance 1984 no company without taking the prior approval of the commission can give any loan to any of its director, his relative or partner or firm in which such director or his relative is a partner or to any company in which any director of the lending company or his relative acquires twenty five percent of the total voting at the general meeting.¹⁶ It is also mentioned that the company cannot give any security for any loan, given to a whole time director or his relative or any such firm or company, by any other person, or given by director or his relative or any such firm or company to any other person.¹⁷ The punishment mentioned in this section for the violators of these provisions is five thousands rupees.¹⁸

Case law:

In The Matter of: Messrs NETSOL, TECHNOLOGIES LIMITED

It was the case of NetSol Technologies Limited. In this case abusive related party

¹⁶ Section 195 of the Companies Ordinance 1984.

¹⁷ Ibid.

¹⁸ Ibid.

transactions in the form of loans to directors were involved. Company filed its annual accounts as well as financial statement with the SECP.¹⁹

Later on SECP while inspecting the annual accounts of the company found that company had given loans of amount ninety lacs to its directors without taking the prior approval of Commission. Hence violation of section 195 of Companies Ordinance had been taken place. It was also found that no particulars regarding this fact were filed with the Registrar of the Companies.²⁰

SECP issued show cause notice to chief executive as well as to director of the company in this regard. Legal adviser of the company took the plea that they are alternate director presently and at the time when loan was given to them they were employees so section 195 of the said Ordinance did not attracted. Legal adviser of the company admitted that mistake had been made by the company for non filing the particulars of said loans with the Registrar and also requested the SECP not to take strict view.

SECP in the said case instead of imposing money penalty directed the company to file particulars of said loan with the Registrar of Companies and also gave directions to comply with the Companies Ordinances in future.²¹

¹⁹ 2006 Company Law Decisions 684,
<http://www.pakistanlawsite.com> (accessed Aug 11, 2009).

²⁰ Ibid.

²¹ Ibid.

In this case although the loans given to directors were given at the time when they were serving as employee of the company which does not invoke the provision of section 195, but still it was related party transaction as they were given the loan by the company considering them part of management and this fact, that it was related party, was not disclosed in the financial statement, which in turn made this transaction as abusive related party transaction. It is oblivious from the case that despite of the fact that it was abusive related party transaction no punishment was imposed on them. In Pakistan although the concept of term related party was incorporated in 2003 but still in practice these provisions are rarely invoked.

Loans to directors are most accruing abusive related party transactions even at international level and consequently these transactions are ban in USA now, whereas in Pakistan such transactions are not only permitted but also very low punishment have been prescribed for the violators of these provisions which fails to deter the directors from violating these provisions and result in accruing abusive related party transactions.

(ii) Approval by the Board of Directors:

In Pakistan the transactions between the Company and any of its directors are subject to the approval by the Board of directors.

According to section 214 of Companies Ordinance, 1984 where a company enters into a contract or a director of the company enter into a contract on behalf of the company in which

he has any interest he shall disclose the nature of his interest at the meeting of the directors.²² It is also mentioned that a director is also considered to be interested if any of his relative is so interested.²³

If a director becomes interested in the contract after the company has entered into contract then he is under obligation to disclose his interest to the company in the next coming meeting of directors.²⁴

A director who has any interest in the proposed contract with the company cannot take part in the discussion of the Board nor can vote, regarding that contract in which he has any interest.²⁵ It is also mentioned in the Ordinance that all the companies will maintained a register of the contracts in which directors have any interest.²⁶

Similarly according to the Ordinance where any officer of a company has any direct or indirect interest in any proposed contract with the company, he cannot enter into that contract without disclosing his interest to the directors and without taking the prior approval of directors.²⁷ The punishment for violating these provisions is also mentioned in the

²² See Section 214(1), Companies Ordinance, 1984, quoted in, Shaukat Mahmood, *Company Law*, 2nd ed.,(Islamabad: Legal Research Centre,1995),364.

²³ Ibid.

²⁴ Ibid.

²⁵ See, Section 216, Companies Ordinance 1984.

²⁶ Section 219, Companies Ordinance 1984.

²⁷ See Section 215, Companies Ordinance, 1984.

Ordinance which is up to rupees five thousand rupees.²⁸

As the present structure of Board in companies within Pakistan is that Board consists of majority of executive directors so the chances of abuse in transactions between the company and any of its directors are high. In order to deter the directors from gaining personal benefits at the cost of company while transacting with the company it is necessary that strict punishments should be imposed on them. But the punishment prescribed for them in Companies Ordinance is nominal money penalty which could not serve this purpose.

In 2003 an amendment was made in the Forth Schedule of the Companies Ordinance, 1984 regarding the approval policy of the related party transactions, which is to be followed only by the listed companies.²⁹ According to which the Board will approve the accounting policy and transfer pricing for related party transactions.³⁰ It is also mentioned that in extremely rare circumstances, where the company decides to use a price other than the arm's length price and if it is in the interest of the company to use such price then it will be approved by the Board as well by the Audit Committee.³¹ However no such requirement has been mentioned for unlisted companies as section 233 and 234 of the Ordinance specifically mentions it that the listed companies will follow the forth schedule and unlisted companies will follow the fifth schedule.³²

²⁸ See Section 214(6) Companies Ordinance, 1984. See also Section 215(2) Companies Ordinance, 1984.

²⁹ See generally, Schedule Forth Part 1 of the Companies Ordinance 1984.

³⁰ Ibid.

³¹ Ibid.

³² See Section 233 and 234 Companies Ordinance 1984.

(iii) Approval of Related Party Transaction by Shareholders:

In 2002 an amendment was made in the Companies Ordinance 1984³³ and provision regarding the investment in associated companies and undertakings was inserted, which is also a form of transaction with related party but investment is not the only form of related party transaction.

According to this section whenever a company decides to invest in an associated company or undertaking, which includes the subsidiary of the company, companies under common management, and where the director of one company is also the director of another company,³⁴ it shall take authority by special resolution before making such investment.³⁵

There are several cases on it.

Case Law:

In the Matter of: Messrs BESTWAY CEMENT LIMITED ³⁶

This is the case of Best Way Cement Limited Company. In this case shares of associated company were purchased in contravention of provisions of law. It was found by SECP during the examination of the annual audited accounts of the company for the relevant year

³³ See Section 208 of Companies Ordinance, 1984 as amended up to 2005.

³⁴ See Section .2(2) Companies ordinance, 1984 quoted in, Shaukat Mahmood, *Company Law*, 2nd ed.,(Islamabad: Legal Research Centre,1995),364.

³⁵ See Section.208 Companies Ordinance,1984 quoted in, Shaukat Mahmood, *Company Law*, 2nd ed.,(Islamabad: Legal Research Centre,1995),364.

³⁶ 2009 Company Law Decision, 56
www.pakistanlawsite.com (accessed Aug 11, 2009).

that Company had purchased 15,193 shares of Mustehkam Cement Limited (MCL), subsidiary of the company without approval of shareholders.³⁷

In response to the SECP query BCL Company informed that subsequent approval of shareholders under section 208 of the Ordinance has been obtained in the AGM held on 31 October, 2007. Whereas, in the record no such agenda item was found in the notice of said meeting as required under section 160 of the Companies Ordinance, 1984. Company also advanced an amount of Rs.209 million to said associated company against issuance of right shares subsequent approval of which was obtained from the shareholders. However, this advance was made in contravention of S.208 of the Companies Ordinance, 1984, which required that the investment in associated company should be made under authority of a special resolution, but no copy of said special resolution was filed with the Registrar of the Companies.³⁸

Provision of sections.208, 160 & 506 of the Companies Ordinance, 1984 had been violated in the case. But SECP, considering the amount of equity investment and the fact that shares against the advance had already been issued, imposed nominal money penalty. Fine of Rs. 20,000 on each Director and Chief Executive of the Company was imposed and to recover an interest on advance to Rs. 209 million not less than the weighted cost of the company.³⁹

³⁷ Ibid.

³⁸ Ibid.

³⁹ Ibid.

4.3.2 Approval requirements under Listing Regulations:

Listing Regulations of the stock exchanges are the source of quasi legislation. In Pakistan there are three Stock exchanges namely Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock exchange. Under the listing regulations almost the same procedure is mentioned as prescribed in the forth schedule. According to which the Board of Directors of listed companies will approve the transfer pricing policy for a related party transaction before entering into such transaction.⁴⁰ It is also mentioned that where a company used a price other than arm's length price for related party transaction which shall be in the interest of the company, than it will be subject to the approval of the Board.⁴¹

It is also mentioned that the record of all related party transactions whether they are executed at arm's length price or not shall also be placed before the Board of Directors at each Board meeting for formal approval along with necessary justification.⁴²

It is obvious from the Companies Ordinance as well as by the listing regulations that the transfer pricing policies regarding related party transactions which are not conducted at arm's length price are also required to be approved by the directors and shareholders who are the ultimate beneficiary have no role in this regard. However, more risk is involved in such type of transactions and chances of fraud in such transactions are also high. Unlike USA, where significant related party transactions are required to be approved by the

⁴⁰ Listing regulation No.38 of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,

[http:// www.kse.com.pk](http://www.kse.com.pk)

⁴¹ Ibid.

⁴² Ibid.

shareholders, the practice of taking approval by the shareholders of the transactions which are not conducted at arm's length price is missing in Pakistan.

As there is requirement both in the Companies Ordinance 1984 as well as in the listing regulations to take the approval of accounting policy for all related party transactions, from the board of directors so the board should consist of majority of independent directors so they can give an independent judgment without the influence of anyone. However according to the listing regulations of Karachi Stock Exchange the composition of the Board of Directors is that there should be seventy five percent of executive directors and twenty five percent of non executive directors including at least one independent director.⁴³ This shows that Board of Directors of companies within Pakistan comprises of majority of executive directors, which is not in line with international standards.

Further a big deficiency in our corporate structure is that not a single provision has been prescribed to formulate a policy regarding related party transaction for unlisted companies. However, the total number of unlisted companies in Pakistan is almost 50,000 as against about 650 listed Companies.⁴⁴ In this unlisted amount more or less 4500 companies are public unlisted companies.⁴⁵ There are many large companies in Pakistan which are unlisted

⁴³ Listing Regulations No. 37 of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007, [http:// www.kse.com.pk](http://www.kse.com.pk)

⁴⁴ Asad Ali Shah, *Good corporate governance: Essential to prevent conflict of interest and fraud Pakistan Experience*, (n.d),

<http://www.oecd.org/dataoecd/5/13/39367990.pdf> (accessed Aug, 24, 2008).

⁴⁵ Zahid Zaheer, *Corporate Governance beyond listed Companies*.(Nov,30 2006). 02, <http://www.picg.org.pk/Download/CGBeyondListedCompanies.pdf> (accessed Aug 21, 2009).

by their choice but also have stakeholders along the controlling shareholders.⁴⁶

4.4 Review by the Audit Committee:

In Pakistan the SECP issued Code of Corporate Governance on March 28, 2002.⁴⁷ This Code of Corporate Governance mandated the establishing of Audit Committee in the listed companies.⁴⁸ This Code is applicable only on the listed companies⁴⁹ and is voluntary for compliance as it adopts 'comply or explain policy. It was made a part of Listing Regulations of all the three Stock Exchanges of Pakistan.⁵⁰ Before the issuance of this Code there was no concept of Audit Committee in Pakistan. Unlike India there is no provision regarding Audit Committee in the Companies Ordinance, 1984 of Pakistan.

The provisions regarding composition of Audit Committee have been mentioned in the listing regulations according to which Audit Committee must comprise of at least three members.⁵¹ The Audit Committee is established by the Board of Directors.⁵² The majority of

⁴⁶ Ibid.

⁴⁷ See Code of Corporate Governance, 2002.

⁴⁸ Ibid.

⁴⁹ See Zahid Zaheer, "Enhancing Corporate Governance Standards in Commonwealth member countries in Asia: Country Paper Pakistan" (paper presented at Workshop by the Commonwealth Secretariat & Global Corporate Governance Forum, Washington , June 17th- 18th 2006, Maldives).

⁵⁰ See e.g., Listing Regulations No. 37 of the KSE, and see also, Listing Regulations of the Lahore Stock Exchange.

⁵¹ See Listing Regulations No. 37 (10) of the Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,

<http://www.kse.com.pk>

⁵² See Nazir Ahmad Shaheen, *Practicle Approach to the Companies Ordinance 1984* (Rawalpindi: Federal Law House , 2004) , 255.

members of Audit Committee are required to be non-executive directors.⁵³ It is also mentioned that the chairman of Audit Committee should be a non-executive director.⁵⁴

The role assigned to the audit committee with reference to the related party transactions is to review them. Under the listing regulations it is mentioned that after approval by the Board of Directors the record of all related party transactions, including exceptional transactions that are not executed at arm's length price shall be placed before the Audit Committee of the company.⁵⁵ However, the same requirement is also mentioned in the schedule forth of the Companies Ordinance of the company that after approval by the board the transfer pricing policy regarding related party transactions will be approved by the audit committee.⁵⁶

The requirement of reviewing the related party transactions by the audit committee makes it necessary that majority of members of audit committee must be independent and expert in accounting so they can properly review the transactions and concerned accounting policy,

⁵³ See e.g., Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,

<http://www.kse.com.pk>

⁵⁴ See Nazir Ahmad Shaheen, *Practicle Approach to the Companies Ordinance 1984* (Rawalpindi: Federal Law House, 2004), 255.

⁵⁵ Listing regulation No.38 (6) of Listing Regulations of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,

<http://www.kse.com.pk>

⁵⁶ See, Schedule Forth of the Companies Ordinance, 1984.

but there is no requirement for the committee members to possess financial and accounting expertise.⁵⁷

4.5 Disclosure of Related Party Transactions:

4.5.1 Disclosure requirement under the Companies Ordinance 1984:

The disclosure requirements regarding related party transactions for listed companies have been mentioned in the forth schedule of the Companies Ordinance, 1984.⁵⁸ Whereas it has also been mentioned in the Companies Ordinance 1984 that the listed companies will follow the forth schedule and unlisted companies will follow the fifth schedule while preparing their financial statements.⁵⁹

(i) Disclosure requirements for Listed Companies:

According to the forth schedule the accounting policy in respect of related party transactions and transfer pricing shall be disclosed to identify that all transactions between the company and a related party or between are at arm's length prices.⁶⁰ In a situation where the company decides to use a price other than the arm's length price, the company is responsible to

⁵⁷ The world bank, *Report on the observance of standards and code(ROSC) Corporate governance country assessment Pakistan,(2005)*, 27,
<http://www.worldbank.org> (accessed July, 30, 2008).

⁵⁸ See Part 1 of Forth Schedule of the Companies Ordinance 1984.

⁵⁹ See, Section 233 of the Companies Ordinance 1984 and also see Section 234 (1)&(2) of the Ordinance.

⁶⁰ Forth Schedule of the Companies Ordinance 1984.

disclose in the financial statement the reason for using such price and the financial impact of such transaction on the company for relevant period presented.⁶¹

However disclosure requirements for the investment in subsidiaries and for granting loans have also been mentioned in schedule forth and fifth respectively to be followed by the listed and unlisted companies.

According to the fourth schedule of the Companies Ordinance the company is required to disclose in its financial statements the long term investment made by the company in its subsidiary or associated undertakings, along with the name of the company in which investment is made and the nature and extent of the investment.⁶² The company is also required to disclose the extent of equity held by the company in such investee company, controlled firms or associated undertaking.⁶³

The company is also required to mention in its financial statement the loans and advances made by the company to any subsidiary company, director, chief executive, managing agents and executives of the company.⁶⁴ Company is also required to disclose the name of the borrower, the amount of the loan or advance and the terms of such loan and advances.⁶⁵

⁶¹ Ibid.

⁶² See part (II) (3) of the Schedule Forth of the Company Ordinance 1984.

⁶³ Ibid

⁶⁴ See part (II) (4) of the Schedule forth of the Company Ordinance 1984.

⁶⁵ Ibid

(ii) Disclosure requirement for Unlisted Companies:

The requirement for unlisted companies is mentioned in the schedule 5th of the Ordinance.⁶⁶

According to which when company has invested in a subsidiary it has to disclose the aggregate amount of the investment and no other disclosure requirement is mentioned in it.⁶⁷

The company is also required to mention in its financial statement the loans and advances made by the company to any subsidiary company, director, chief executive, managing agents and executives of the company, however according to this schedule no further information is required be disclosed by the unlisted companies.⁶⁸

4.5.2 Disclosure requirements under Listing Regulations:

According to the listing regulations every listed company shall maintain a party wise record of each related party transactions, on yearly basis along with all necessary documents.⁶⁹

These documents includes;

Name of related party, nature of relationship with that party, nature and amount of transaction, terms and conditions of transaction including the amount of consideration

⁶⁶ See generally, Fifth Schedule of the Companies Ordinance 1984.

⁶⁷ See part (II) (3) of the Schedule Fifth of the Company Ordinance 1984.

⁶⁸ See part (II) (4) of the Schedule Fifth of the Company Ordinance 1984.

⁶⁹ Listing Regulation No.38(3) of the Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,
[http:// www.kse.com.pk](http://www.kse.com.pk)

received or given, basis or method for determining such consideration along with the detail of computation of transfer price.⁷⁰

According to the listing regulations all listed companies are also required to publish and circulate a statement along with their annual reports that they have complied with the best practices on Transfer Pricing.⁷¹

In addition Pakistan has also adopted IAS which are applicable only to the listed companies, although they are not actively exercised by all the companies, as it is mentioned in the code of corporate governance of Pakistan that the International Accounting Standards, as applicable in Pakistan, have to be followed in preparation of financial statements and any departure from their exercising should be disclosed adequately.⁷²

The disclosure requirements as prescribed in the listing regulations as well as in the Companies Ordinance are exactly the same. In addition the requirements mentioned in the IAS 24 regarding disclosure of related party transactions are also similar to the requirements prescribed in the Companies Ordinance, 1984 as well as in the listing regulations. There is need that in spite of formulating similar rules again and again concentration should be given on their compliance.

⁷⁰ Ibid.

⁷¹ Listing Regulation No.38(3) of the Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,
[http:// www.kse.com.pk](http://www.kse.com.pk)

⁷² See xix(d) of Code of Corporate Governance 2002.

Further the disclosure of related party transactions prescribed in forth schedule of the Ordinance as well as prescribed in the listing regulations is only for the listed companies. No requirements have been prescribed for the unlisted companies, whereas the total number of unlisted companies in Pakistan is far more high than listed companies. In Pakistan there are over 50,000 unlisted public companies and private companies.⁷³ As transparency in related party transactions can be achieved by extensive disclosure of such transactions but in Pakistan no rules of transparency have been mentioned for unlisted companies which comprise a big area of corporate sector of Pakistan.

4.6 Auditing of Related Party Transactions:

Related party transactions are always a difficult audit area and auditors need to pay special attention during the course of the audit of an entity's financial statement.⁷⁴

According to the listing regulations of the Karachi Stock Exchange all listed companies shall present the record of related party transactions together with all relevant documents, agreements to the statutory auditor for the purposes of auditing.⁷⁵ It is also mentioned that

⁷³ Zahid Zaheer, *Corporate Governance beyond listed Companies*, (Nov, 30, 2006), 02, <http://www.picg.org.pk/Download/CGBeyondListedCompanies.pdf> (accessed Aug 21, 2009).

⁷⁴ Jacqueline Lam, *Potential risk of elated party transactions (RPT's) and its impact on audit*, (July 2006). <http://www.pkf-hk.com/pdf/Audit/060720%20JL.%20-> (accessed Aug 24, 2009).

⁷⁵ Listing Regulation 38 (9) of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007, [http:// www.kse.com.pk](http://www.kse.com.pk).

all listed companies shall ensure that statement of compliance with the best practices of Transfer Pricing is reviewed and certified by statutory auditors.⁷⁶

Recently Karachi Stock Exchange issued an amendment in the listing regulations. According to which the external auditor is required to review the statement of compliance with best practices of the code of corporate governance prepared by the directors with regard to related party transactions and give a statement in the audit report in this regard.⁷⁷

But in response to this amendment made by the KSE, The Institute of Chartered Accountants of Pakistan 'ICAP' issued a circular and specified the role of auditor in this regard. The Institute of Chartered Accountants of Pakistan is of the view that auditor is required to review only the process, that is either these transactions have been placed before the board for approval and then before the audit committee or not. Auditor is not required to carry out any procedure to determine whether related party transactions have been conducted at arm's length price or not.⁷⁸

In this sense this amendment is of no use as auditor is only required to review the procedure regarding the approval of related party transactions and is not required to see either these transactions have been approved fraudulently or are in the best interest of the company.

⁷⁶ Listing Regulation 38(10) of Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007,
[http:// www.kse.com.pk](http://www.kse.com.pk).

⁷⁷ See Listing Regulation No. 37(xiii a) of the Karachi Stock Exchange (Guarantee) quoted in, Circular No.9/2009 of Institute of Chartered Accountants of Pakistan(Aug 11,2009)
http://www.icap.org.pk/userfiles/file/TechnicalDepart/Circular_No_9.pdf (Aug 27, 2009).

⁷⁸ See, Circular No.9/2009 of Institute of Chartered Accountants of Pakistan (Aug 11, 2009),
http://www.icap.org.pk/userfiles/file/TechnicalDepart/Circular_No_9.pdf (accessed Aug 27, 2009).

In the Code of Corporate Governance, 2002 and in the listing regulations no procedure is prescribed which should be followed by the auditor while auditing related party transactions. Pakistan has now adopted the International Standards on Auditing 'ISAs' and ISA 550 prescribed the procedural guidelines for auditing related party transactions.⁷⁹ But practically they are not mandatorily followed by the auditors and there are several cases which show that auditors while auditing the financial statement of the company fail to comply with these standards.

Case Law:

(i) In The Matter of: Messrs Mehboob Sheikh & CO. CHARTERED ACCOUNTANTS:

This is a case of Mehboob Sheikh and Company, a Company of Chartered Accountants. In this case auditor audited the accounts of the company for the year ending June 30, 2006. Examination of the accounts of the company had revealed that the auditor had qualified his report.⁸⁰ Annual accounts along with the director's and auditor report were sent to the SECP by the company.

⁷⁹ See e.g., AICPA, *Proposed International Standards on Auditing 550(revised):Related parties*, (Jan 09,2007),04, http://www.aicpa.org/download/auditstd/2007_01_agenda_material/2007_01_ASB_Agenda_Item_5A-Revised_ISA_550.pdf (accessed July12, 2008).

⁸⁰ 2008 Company Law Decisions, 305, www.pakistanlawsit.com. (accessed ,Aug 11, 2009).

In this case detailed scrutiny of the accounts of the company was conducted by the Enforcement Department of the SECP in the light of the provisions of the Companies Ordinance, International Accounting Standards and International Auditing Standards which revealed certain irregularities.⁸¹ It was found that management prepared the annual account of the company without following the International Accounting Standards and there were irregularities in them which are following:

- (a) The Company suffered loss during the period under review but the auditor instead of mentioning loss used the word "profit" in his report.
- (b) Accounting policies of the company for exchange gain & loss were contrary to requirements of the 4th Schedule of the Ordinance.
- (c) Accounting policy for deferred taxation was not formulated in accordance with the requirements of International Accounting Standards.
- (d) The Company was not charging depreciation on its fixed assets since 2000.⁸²

But auditor report was silent regarding these irregularities. Enforcement department of the SECP felt concern about the quality of audit conducted by the audit and the auditor report made on the accounts of the company.⁸³

It was found that auditor, in the present case, failed not only to report the non-compliances of the company with International Accounting Standards, but had also failed to make his

⁸¹ Ibid
⁸² Ibid.
⁸³ Ibid.

report in accordance with International Standards on Auditing. Auditor took the plea that the default was not willful but was not accepted.

Hence in this case penalty of fine Rs.25,000 was imposed on auditor under S. 260(1) of the Companies Ordinance, 1984.⁸⁴

(ii) In The Matter of: Messrs GANAGT & CO. CHARTERED ACCOUNTANTS:⁸⁵

This is a case of Gangat and Company, a company of Chartered Accountants. In this case also auditor was found not to comply with the International Standards on Auditing as well as with International Standards on Accounting.⁸⁶

In this case it was found by the Enforcement Department of the Commission during examination of account of company concerned that the Auditors' report regarding the accounts of the company had not been made in compliance with the requirements of S.255 of Companies Ordinance, 1984.

It was also found that the auditor did not consider the matters pertaining to previous years' accounts of the company while issuing audit report.⁸⁷ Enforcement Department of the SECP issued a show-cause notice to the auditors with regard to their responsibilities under the

⁸⁴ Ibid.

⁸⁵ 2007 Company Law Decisions,1256, www.pakistanlawsit.com. (accessed Aug, 11, 2009).

⁸⁶ Ibid.

⁸⁷ Ibid.

Companies Ordinance, 1984, International Accounting and Auditing standards. In this case also penalty of fine of Rs.25,000 each under subsection (1) of S.260 of Companies Ordinance, 1984, was imposed on all partners of the Auditing Company.⁸⁸

(iii) Messrs Salman & Company, Chartered Accountants

Versus

Institute of Chartered Accountants of Pakistan⁸⁹

In this case appeal was filed by auditor against the void order imposing punishment of suspension of membership for five years by investigation committee of ICAP. In this case auditor, audit the accounts of company. After auditing annual accounts of Company were sent to the SECP. SECP on scrutiny found that there were certain irregularities regarding the preparation of annual accounts of company in accordance with applicable International Accounting Standard as well as forth schedule of Companies Ordinance 1984, the auditor was found to be failed to perform the audit in accordance with auditing procedure.⁹⁰

The auditor admitted his fault that he negligently audit the accounts of company. the High Court considering the facts of the case as well as the admission of the auditor reduce the punishment suspension of membership five years suspension to one year suspension.⁹¹

⁸⁸ Ibid.

⁸⁹ 2004 Company Law Decisions, 1419.

www.pakistanlawsit.com. (accessed Aug, 11, 2009).

⁹⁰ Ibid.

⁹¹ Ibid.

Pakistan despite of making its own auditing manuals like many other jurisdictions including India, Australia, America, has adopted the International Auditing Standards. But practically they are not mandatorily followed by the auditors. Although the auditing manuals provides the complete guideline for designing the audit of a company but auditors fails to comply with them.

These cases also reveal that the penalty for non compliance with the International Auditing Standards is not sufficient to deter the auditor from non compliance with the Auditing Standards. Further there is no system of independent oversight of the auditing profession, which can keep a better check on auditors⁹² like USA where Public Company Accounting Oversight Board has been formulated for the purpose of over sighting the auditing profession. The main role of which is to conduct a continuous inspection of the auditing firms in order to check their degree of compliance with rules and standards.

Auditor Report:

After performing the audit the auditor gives the report under section 255 of the Companies Ordinance 1984.⁹³ According to the Ordinance the auditor gives the report on the matters

⁹² Zahid Zaheer, *Workshop by the Commonwealth Secretariate and Global Corporate Governance Forum, Washington* (June 17-18, 2006), 13, www.ifc.org/.../Workshop_June06.../Presentation+PICG-+Pakistan+Maldives+workshop.ppt (accessed Aug, 28, 2008).

⁹³ Section 255 of the Companies Ordinance, 1984, quoted in, Shaukat Mahmood, *Company Law*, 2nd ed., (Islamabad: Legal Research Centre, 1995), 364.

specify in the section 255 of the Ordinance. However no specification with regard to the disclosure of related party transactions has been mentioned in it.⁹⁴

As under the law of Pakistan the accountancy policy and transfer pricing policy regarding related party transactions of a company have to be approved by the directors and shareholders, who are the investors and can be effected by these transactions, have no control in this regard. Therefore an independent view, that is the auditor report, is very important for them which the auditor made to them at the end of the financial year. But the auditor report as required under the Companies Ordinance, 1984 and in the listing regulations does not disclose sufficient information regarding related party transactions, which is necessary to determine the transparency in these transactions. Auditor has to give only a statement that either Company has complied with the transfer pricing policy or not. However in India CARO (Order) 2003⁹⁵ was issued which requires the auditor to disclose in his report specific observations regarding related party transactions.

⁹⁴ See generally section 255 of the Companies Ordinance, 1984 and also see, Listing Regulations No.38 of the Karachi Stock Exchange (Guarantee) Limited as amended on February 21, 2007, <http://www.kse.com.pk>

⁹⁵ Anil Khicha, *D. Audit & Assurance - Related Party Transactions - You Need to know while conducting audit.* (n.d), <http://articles.manupatra.com/PopOpenArticle.aspx?ID=45422dbf-6e94-4bbf-856e-e78ae9d43059&txtsearch> (accessed Aug 24, 2009).

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion:

The transaction between the company and the related party are usual part of business but if rules governing these transactions are not rigid, these transactions can be disguised by fraud causing a great loss and damage to the company. Enhanced rules and regulations are required to avoid abusive related party transactions and to increase transparency in the area of related party transactions. In fact financial system can be benefited if related party transactions are reasonable, but if these transactions are unfair they can causes serious losses to the company.

The issue of related party transaction requires particular attention because of the risk of fraud attached to them which can affect the company and its share holder badly. If these transactions are not fair, they can ultimately bring the Company at the edge of bankruptcy. The same which happened in USA in Enron and Parmalat cases and more recent in India in Satyam case in year 2008.¹

¹ See, Salil Tripathi, "Restoring faith in Brand India", *Far Eastern Economic Review* (March 06, 2009). <http://www.feer.com/essays/2009/march/restoring-faith-in-brand-india> (accessed Aug 24, 2009).

The basic argument is that related party transactions are common in commercial area and cannot be banned for the reason that to put ban on such transactions will result in reducing the scope of business as the term related party includes wide variety of persons and enterprises. Therefore, by keeping check on such transactions the abuse of such transactions can be avoided on one hand and scope for conducting business with variety of persons will also be expended on the other

In order to keep check on such transaction and to bring transparency in such transactions a complete set of rules is required which generally includes approving these transactions from the majority of independent directors and by disclosing fully these transactions in the financial statements after proper auditing.

In this dissertation legal frameworks of these transactions in other jurisdictions like USA and India have also been studied at length and it has been observed that in those jurisdictions especially in USA the rules regarding these transactions are more stringent as compared to Pakistan.

In Pakistan Companies Ordinance 1984 and listing regulations of the Stock Exchanges deal with this area. Legal framework of Pakistan regarding related party transactions has also been analyzed to check its compatibility against abusive related party transactions. Unfortunately the prescribed legal framework of related party transaction in Pakistan contains some deficiencies and inherent weakness on one hand and is also

restrictive in its scope on the other. Therefore, in order to prevent the abusive related party transaction entirely, there is a need to enhance the existing legal frame work of such transactions in Pakistan.

5.2 RECOMMENDATIONS:

The regulations regarding related-party transactions in Pakistan are much weaker with respect to their efficiency to combat abusive related-party transactions, as compare to other jurisdictions. Some important recommendations in this regard, which will if incorporated in the present regulations will certainly prove helpful in avoiding abusive related-party transaction, are as follow:

5.2.1 Recommendations regarding Approval of Related Party Transactions:

1. In our corporate structure there is not a single provision for unlisted companies regarding the formulation of transfer pricing policy. There is a need that steps should be taken to enhance the existing regulations beyond listed companies to cover the unlisted ones which comprise a big area of corporate sector of Pakistan.
2. The regulations in Pakistan require the approval of transfer pricing policy by the Board of directors so it is necessary the number of independent non executive directors on

the Board should be increased because independent directors can decide the matters without any influence.

3. Approval of related party transactions that are not at arm's length price should be taken by the majority of share holders so as to bring more transparency in this area and to increase the confidence of shareholders on the functioning of the company.

5.2.2 Recommendation regarding Review by the Audit Committee:

Majority of members of the Audit Committee must be made independent and expert in accounting so they can properly review the related party transactions and their concerned accounting policy.

5.2.3 Recommendation regarding Disclosure of Related Party Transaction:

Regulations regarding disclosure of related party transactions for unlisted public companies, which comprise a big area of corporate structure of Pakistan, should be prescribed in order to bring more transparency in this area. There is need that steps should be taken by SECP to formulate disclosure requirements for unlisted public companies as well or at least extend the present regulations to utmost possible extent to cover the unlisted public companies.

5.2.4 Recommendation regarding Auditing of Related Party Transactions:

1. An organizational structure for the purpose of independent oversight of the auditing profession should be established in order to improve the credibility of auditing profession. Steps should be taken by the SECP to perform this job itself or permit any other existing body like the Institute of Chartered Accountants of Pakistan to carry out this task.

2. Strict punishment should be imposed on the auditors practically, which would deter them from non observance of the auditing standards.

3. Auditors should be required to give proper disclosure of related party transactions in their audit reports, which would certainly increase the reliability and fairness of such transactions.

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