Good Governance Guide

Issues to consider when developing a policy for managing related party transactions in not-for-profit organisations

Governance Institute of Australia

Not-for-profit sector

For the purposes of this guide, we refer to the governing body of an organisation as the 'board'. However, it may have another name, such as 'council,' management committee' or 'synod'.

There are significant risks associated with related party transactions requiring identification, management and disclosure. It is **good governance** for organisations to develop policies to manage these risks effectively and for governing bodies to monitor management's implementation of these policies.

What is a related party?

A related party is a person or organisation (for example, suppliers, contractors and their owners and staff, or a NFP beneficiary) that is related (or has connections) to the NFP organisation. The term can refer to a diverse range of people and organisations and may include pre-existing relations with directors (or responsible persons in the case of charities), key management personnel, employees, volunteers, their families, and friends.

Many NFP organisations gain special terms from suppliers or contractors because of commitments of the supplier/contractor to directors or employees or volunteers of the NFP organisation. These connections with the NFP organisation can work to benefit of the NFP. However, there is also the possibility that such connections may lead to inadequate scrutiny of any transactions arising from them, which may be detrimental to the NFP.

Purpose of a policy on related party transactions

It is **good governance** for NFP organisations to document a policy for managing related party transactions to ensure that related party transactions are managed for the benefit of the organisation and not that of an individual. Related party transactions can benefit the NFP organisation, but without a sound policy setting out how they are managed, there is a risk that the transaction will not be, or may be perceived not to be, in the best interests of the NFP organisation.

Any policy or process for managing related party transactions will identify those who are related parties of the NFP organisation. It is helpful to include examples of the people and organisations that would be considered related parties of the NFP organisation, or the organisation may consider identifying known related parties in its policy.

The purpose of a related party policy or process should be to:

- educate directors, employees and volunteers so that they can recognise potential related party transactions as they arise
- provide direction as to whom a director, employee or volunteer can consult should they be uncertain if a transaction is in fact a related party transaction
- establish a clear process for identifying, managing and disclosing transactions with related parties.

Why managing related party transactions is important

A related party transactions policy helps a NFP organisation to implement processes that reduce the risk that transactions are entered into or maintained that are not in the best interests of the NFP organisation. This can occur where the related parties are in a position to influence a decision of whether a benefit is provided to them and the terms of the provision of that benefit.

The provision of a benefit to a related party to a transaction may be to the detriment of the interests of the NFP organisation involved in the transaction or its members.

An effective policy documenting the process for managing related party transactions will assist to:

- protect the interests of the members and stakeholders of the NFP organisation
- ensure appropriate allocation of the NFP organisation's resources and funds
- protect the NFP organisation's reputation and engender public trust in the NFP organisation.

What is a related party transaction?

A related party transaction is one in which a related party obtains a benefit as a result of the transaction with the NFP organisation.

The circumstances in which the provision of a benefit may occur can be quite broad and include:

- providing a financial benefit indirectly, for example via other organisations
- giving a financial benefit by making an informal agreement or arrangement
- situations where no money is paid but where an advantage is provided.

The NFP organisation should consider documenting in the policy examples of benefits and the circumstances in which a benefit might be provided by the NFP organisation. These can include the NFP organisation:

- **Buying goods and services, for example**
  - The local football club purchases soccer balls and netting from a member of the management committee, who runs a local sporting goods store. The owner of the sporting goods store offers the NFP organisation a significantly discounted price that makes the purchase of the sporting gear more affordable. The football club seeks quotes from two other sporting goods stores, and finds that they cannot match the discounted price offered by the store owned by the member of the management committee. This related party transaction is in the best interests of the organisation.
  - A NFP organisation issues a tender for the provision of IT services, and one of the directors, who runs an IT company, has his company put in a proposal and that proposal wins the tender. The director is a related party, but the proposal can be shown to be the best offer. This related party transaction is in the best interests of the organisation.
  - A charity which provides affordable housing to low income families decides to install roofing insulation in its existing properties in order to make them more environmentally sustainable and reduce heating and cooling costs for their tenants. The contract for installation is awarded to a company owned by the brother of one of the responsible persons of the charity. The company is newly formed and has never installed insulation before. No tender process was undertaken or quotes obtained from other providers. This related party transaction is unlikely to be in the best interest of the organisation as steps have not been taken to ensure that this is the best offer available to the organisation.
- **Lending money or providing guarantees, for example**
  - Some closely-held charities have married couples, or family members, or a few friends as the responsible persons. The responsible persons of a small closely-held charity that operates online raising money to assist children with a debilitating disease, decide to provide the responsible persons (themselves) with interest-free loans, or loans with no terms of when they are due to be paid back. The charitable funds are being used for private purposes and this related party transaction is not in the best interests of the organisation. The Australian Charities and Not-for-Profits Commission (ACNC) notes on its website that ‘a significant issue for charities is that of private benefit — where the resources of the charity are used for the benefit of those close to or related to the charity, rather than for the charity’s beneficiaries, and for its charitable purpose’.
- **Awarding grants and gifts, for example**
  - A NFP organisation that provides grants to filmmakers awards a grant to a director of the organisation who applied for funding to make a film. The directors have all been on the board for at least six years. Funding was provided to only two filmmakers in the financial year. The organisation may be of the view that the related party transaction is in the best interests of the organisation and should be supported over other applicants, because the track record of the grant applicant is of excellent quality, but there could be a perception that the directors have improperly awarded the grant based on a pre-existing personal relationship and that the director received a financial benefit because they were able to influence the decision. Even if the director did not vote on the matter, this related party transaction could pose a reputation risk to the NFP organisation.
  - The responsible persons of a small charity that is a religious institution provide the gift of a motor vehicle to each of the responsible persons

(themselves). The responsible persons are of the view that the motor vehicle assists them to pursue the interests of the charity, providing them with mobility to promote the religious institution and its mission. However, a gift of this size may not to be in the best interests of the organisation. It should also be noted that a similar related party transaction could occur if the responsible person was provided private use of a vehicle, even if ownership was retained by the NFP organisation.

- **Employing staff, for example**
  - A charity dedicated to assisting at-risk youth who are involved in hip-hop, by creating dance spaces and creating opportunities for them to be part of theatre shows and performances, decides to develop a website. It hires the daughter of one of the responsible persons in a new, permanent part-time role to create the new website and keep it updated, although it is unclear if she has experience in developing websites. The same charity hires the other responsible person's nephew to organise events and media, although he has just completed a science degree and has no experience in public relations. No other candidates were considered. These related party transactions are not in the best interests of the organisation.
  - A medium-sized charity is fundraising in multiple states but does not appear to be conducting significant charitable activities. It did, however, make large payments to the responsible persons. It could not show that these payments were not excessive and at arms' length. These related party transactions are not in the best interests of the organisation. Concerns about potential fraudulent activity may also be raised in relation to these transactions.
- **Leasing equipment or premises, for example**
  - A NFP organisation that owns land which it uses for operating recreational camps for disadvantaged children allows the daughter of the director, and her family, to live in one of the vacant houses on the property rent-free. No written lease is entered into and the tenants are allowed free use of electricity and gas as there is no separate meter for the house. No obligations are placed on the tenant to maintain the house or perform any caretaker services for the NFP organisation. The house was not offered for rent on the open market. This related party transaction is not in the best interests of the NFP.
- **transferring intellectual property (IP), for example**
  - The directors of an industry association transfer the copyright or patents in new IP that were developed by the association and that are specific to that industry to one or more directors, who then run a consultancy providing services utilising that IP. The industry association itself then purchases those services from the directors running the consultancy. This is unlikely to be in the best interests of the organisation, given that a valuable asset paid for by the organisation has been donated without any consideration being offered for control of the asset. Concerns about potential fraudulent activity may also be raised in relation to this transaction.

Conflicts of interest

The management of related party transactions cannot be separated from the process for managing conflicts of interest.

A conflict of interest arises when the interests of directors (or those of their families, friends or other organisations with which they involved) are incompatible or in competition with the interests of the NFP organisation. Such situations present a risk, real or perceived, that directors may make decisions based on these external influences, rather than the best interests of the NFP organisation.

Directors have a duty under common law and under the Corporations Act (and the ACNC governance standards if the organisation is a charity) to act in the best interests of the NFP organisation that they serve. Directors should not seek to benefit from the NFP organisation and should not be influenced by their wider interests when making decisions affecting the organisation. Directors have obligations not to improperly use their position, or information available to them in their position as a director to gain an advantage for themselves or someone else or to cause detriment to the NFP organisation.

Directors are obliged to disclose conflicts of interest and may not be able to be present or vote on any matter in certain circumstances. Directors also should not use their relationship with other directors to lobby for their projects. Where a NFP organisation is structured as a company limited by guarantee, there are specific requirements in the Corporations Act relating to 'material personal interests' with which directors must also comply.

A director should also consider disclosing a potential or perceived conflict of interest. These conflicts can affect the reputation of an NFP organisation even where no actual conflict exists if they are not properly managed.

A common conflict within NFP organisations is a conflict of loyalty. This is particularly the case in federated structures where directors often sit on the national board as the state or regional representative and they also sit on the state or regional board, which has decision-making powers. Directors in these situations need to be particularly aware of and sensitive to conflicts of loyalty. Often they are difficult to manage effectively without restructuring the governance framework, so that the organisation is no longer federated, with the state boards taking on an advisory role rather than a decision-making one. An alternative can be to introduce independent directors, so that the national board is not comprised solely of representative directors.

Managing related party transactions will be part of the NFP organisation's process for managing conflicts of interest. The policy relating to related party transactions may either refer to the NFP organisation's policy on conflicts of interest or be part of it.

It is **good governance** for a policy on conflicts of interest for a NFP organisation to:

- define a conflict of interest
- describe what is expected of a director in identifying and disclosing a conflict
- provide for disclosure of conflicts, including the maintenance of a conflicts register and including declarations of interest as a standing agenda item at board meetings
- describe what is expected of a director if the conflict is significant
- describe how the board will vote on matters involving a director's interest, and consider whether the director should be present and able to vote
- enable a NFP organisation, that is a company limited by guarantee, to comply with its statutory obligations relating to a 'material personal interest' of a director. Not-for-profit organisations that are incorported associations may also need to consider their obligations under state-based legislation.

See *Good Governance Guide: Conflicts of interest in not-for-profit organisations* which sets out more detail on conflicts of interest and how to manage them.

Process for managing related party transactions

The process requiring directors to disclose conflicts of interest assists governing bodies in determining whether transactions being contemplated or being entered into are in fact related party transactions.

It is **good governance** for a policy on managing related party transactions to cover the following:

- related party transactions are disclosed to the board by directors and employees
- clarification of when related parties can or cannot take part in discussions or decisions relating to those transactions, and in particular, whether directors should leave board meetings for the duration of discussions and not vote on the related party transaction
- employees who make decisions or directors who vote on related party transactions act in the best interests of the NFP organisation
- board minutes reflect discussions of any related party transactions and the conflicts register is updated with regard to the individual and nature of the conflict.

It is **good governance** for the NFP organisation's policy to contain guidance to assist directors, managers, employees and volunteers on how they can act in the best interests of the NFP organisation when dealing with related party transactions, to ensure that the transaction benefits the organisation. When considering a related party transaction, directors of a NFP organisation can ask themselves the following questions:

- Has there been an independent process for selecting the most appropriate party (who may in fact be a related party) to provide the goods or services that are the subject of the transaction?
- Have quotes been obtained from other providers who are independent of the organisation?
- Are the terms comparable with similar transactions with non-related parties?
- Does the related party have the proven capacity to provide the goods or services that are the subject of the transaction?
- Was the employment role appropriately advertised and were other candidates considered?
- Has the related party been offered an employment position on their merits?

- Is the remuneration proposed for the role reasonable?
- Should independent expert advice be sought and, if so, has it been received on the transaction and acted on accordingly?
- Has there been a proper bargaining process concerning the transaction?
- Was the interested director/responsible person excluded from negotiating the related party transaction on behalf of the NFP organisation?
- Has there been a genuine attempt to identify and consider alternative transactions with non-related parties?
- Have transactions with related parties been considered where they are in the best interests of the organisation, and not just excluded?
- Has consideration been given to the likely response by stakeholders to news that the specific related party transaction has been entered into?
- Do the minutes show adequate explanation of the process and items for consideration relating to related party transactions?
- Are there effective mechanisms in place for identifying, considering and disclosing potential related party transactions?

Managing related party transactions is important, regardless of the size of the NFP organisation.

Public company limited by guarantee

A NFP organisation that is a public company limited by guarantee must satisfy the Corporations Act requirements concerning related party transactions and may be required to obtain member approval of the transaction unless certain exemptions apply. A related party transactions policy for this type of NFP organisation will need to:

- establish a clear process for obtaining approval that a potential related party transaction falls within the exemptions
- ensure that related party transactions that require member approval are put before members
- ensure that the NFP organisation meets its legal and regulatory obligations.

Incorporated associations may also need to consider their obligations under state-based legislation.

See *Good Governance Guide: Issues to consider when developing a policy or process for managing related party transactions* for more detail.

Reporting related party transactions

Some NFP organisations will be required to prepare financial statements in accordance with accounting standards and may be required to disclose related party transactions as part of their reporting requirements. All NFP organisations are strongly encouraged to disclose related party transactions to their members even if they do not prepare financial statements. Such disclosure could be made as part of their communications to members keeping them apprised of the NFP organisation's activities and outcomes.

See

- *Good Governance Guide: Conflicts of interest in not-for-profit organisations*
- *Good Governance Guide: Issues to consider when developing a policy or process for managing related party transactions*
- *Good Governance Guide: Issues to consider when developing a policy on disclosure of and voting on matters involving a director's material personal interests*
- *ACNC: Managing charity money — a guide for board members on managing finances and meeting ACNC duties*
- *ASIC Regulatory guide 76: Related party transactions*
- *Accounting standard AASB 124 Related party disclosures*