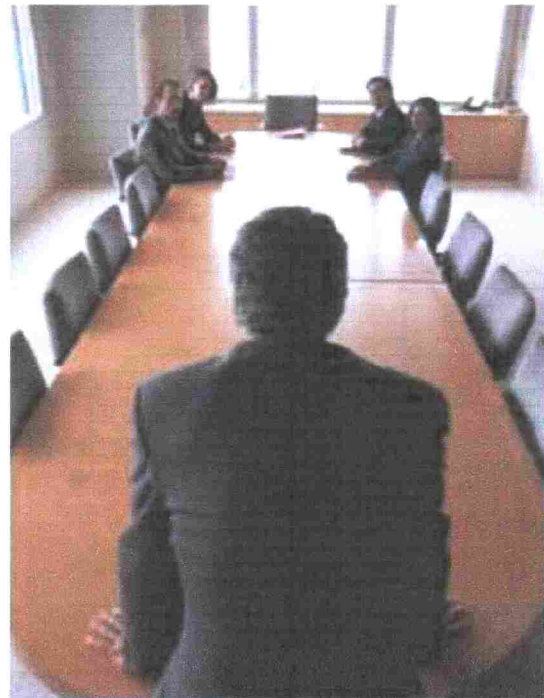


Corporate Governance in Central Public Sector Enterprises



Recently, leading national newspapers reported that the Cabinet Secretary to the Government of India has reviewed the effectiveness of the corporate governance in the Central Public Sector Enterprises (CPSEs) based on the Report¹ of the Comptroller and Auditor General of India. In the liberalised economic policy regime, the corporate sector has been assigned a major role as the driver of growth and development process. In the backdrop of the legal framework of corporate governance as envisaged and evolved over the years since its inception, this article throws light on some systemic deficiencies in the implementation of corporate governance in three hundred odd CPSEs which include 44 listed public enterprises with some suggestions for improvement.



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The Indian corporate sector comprises two sectors: public sector and private sector. The public sector is formed by the central and state governments owned companies and statutory corporations. While in 1957, there were 29357 companies, of which 29283 companies were in private sector leaving only 74 companies in public sector. In the liberalised economic policy regime, the corporate sector has been assigned a major role as the driver of growth and development process. As on 31st March 2009, there were 7,86,774 companies in India, including 1591 public enterprises.

This article essentially deals with only three hundred odd CPSEs which include 44 listed public enterprises. Before

¹ Report No. CA 22 of 2009-10 Union Government (Commercial) Comptroller and Auditor General of India.

analysing the systemic deficiencies in the implementation of corporate governance, it is important to briefly cover the regulatory framework of corporate governance in India as reflected in The Companies Act, 1956, Clause 49 of the listing agreement with stock exchanges and the various guidelines issued by the Department of Public Enterprises (DPE) of the Government of India. While significant observations contained in the C&AG's report are highlighted, *inter alia* an attempt has been made to identify major differences in the provisions of the Sarbanes Oxley (SOX) Act, 2002 of the USA and clause 49 of the listing agreement.

Regulatory Framework of Corporate Governance In India

(a) Provisions of Companies Act, 1956:

The amendments to Sections 217 and 292 of the Companies Act, 1956, made applicable from December 13, 2000, set the tone for Corporate Governance in India. The following requirements were inserted in the Companies Act, 1956, to strengthen the corporate governance:

- (i) Preparation of Directors' Responsibility Statement to increase the accountability of the Directors [Section 217 (2AA)] and
- (ii) Formation of Audit Committee by every public limited company having paid up capital of not less than Rs. five crore [Section 292A].

(b) Clause 49 of Listing Agreement of SEBI:

The Securities and Exchange Board of India

(SEBI), on the recommendations of Kumar Mangalam Birla Committee, specified principles of corporate governance by introduction of new clause 49 in the Listing Agreement with the Stock Exchanges in 2000. After enactment of Sarbanes Oxley Act (SOX) in 2002, the corporate governance practices were reviewed and SEBI on the recommendations of N.R. Narayana Murthy Committee revised Clause 49 of the Listing Agreement in August 2003 which was again revised in October 2004 and made applicable from 1st January 2006. The Clause 49 is mandatory for all listed companies having a paid up capital of Rs. 3 crore and above or net worth of Rs. 25 crore or more.

The major requirements of the revised Clause 49 were representation of independent directors on the Board and Audit Committee, code of conduct for all board members and senior management, preparation of management discussion and analysis report as part of the annual report to the shareholders, certification by chief executive officer (CEO) and chief financial officer (CFO) on internal control system, separate section on corporate governance in company's annual report, certification by auditors or practising company secretaries regarding compliance of conditions of corporate governance. Though clause 49 of listing agreement of SEBI covers the good corporate governance aspects of SOX Act, there are some differences between requirements of corporate governance of SOX Act and Clause 49 as briefly explained below:

Provisions in SOX Act	Provisions in Clause 49
Nature: SOX act is an Act to protect investors by improving the accuracy and reliability of corporate disclosures.	Clause 49 is a contractual obligation between listed companies and stock exchanges.
Oversight: <ul style="list-style-type: none"> • Securities Exchange Commission (SEC) oversees the corporate governance by companies. • Public Company Accounting and Oversight Board (PCAOB) oversees the functioning of auditors. 	<ul style="list-style-type: none"> • Stock exchanges oversee the corporate governance by companies. • Statutes and ICAI oversees the functioning of auditors.
Standards for auditing: PCAOB issues standards for auditing, quality control and independence.	ICAI issues standards for auditing, however, no such independent body has been prescribed.
Fraud: Any fraud-material or not to be reported to	Instances of 'significant fraud' to be

auditors and audit committee.	reported.
Whistle blower policy: Whistle blower protection provided for company employees.	Whistle blower policy is a non mandatory requirement.
Auditors Independence: <ul style="list-style-type: none"> Unlawful to contemporaneously render specified non-audit services. Audit partner rotation. 	<ul style="list-style-type: none"> Clause is silent on auditors' independence. However, ICAI guidelines and provisions of Companies Act are available. For PSEs, system of prohibition of certain non-audit services exists in the appointments of auditors made by C&AG. No provisions for rotation. However, system of rotation of audit firms exists in case of appointment of auditors of PSEs by C&AG.
Audit Committee comprises of independent directors only.	Audit Committee should comprise of two third or more independent members.

(c) DPE's guidelines for CPSEs:

For CPSEs, the Department of Public Enterprises (DPE) issued guidelines on the composition of Board of Directors in March 1992. These guidelines provide that at least one-third of the Directors on the Board of a CPSE to be non official Directors. For listed CPSEs, DPE issued guidelines in November 2001 on the composition of the Board of Directors which provide that the number of independent directors should be at least one-third of the Board if the Chairman is non-executive and not less than 50 per cent, if the Board has an executive Chairman. The relevant provisions of Clause 49 of the Listing Agreement with Stock Exchanges issued by SEBI in 2000 formed part of these guidelines.

The DPE has also issued separate guidelines on corporate governance for CPSEs in June 2007. These guidelines, though voluntary in nature, should be followed by all CPSEs in order to protect the interests of shareholders and relevant stakeholders. While issuing these guidelines, DPE instructed CPSEs that the compliance with these

guidelines should be reflected in Directors' Report, Annual Report and Chairman's Speech in the Annual General Meeting.

Applicability of Corporate Governance Requirements for CPSEs

As explained above, the corporate governance requirements are contained in Clause 49, Companies Act, 1956 and DPE's guidelines. The extent of applicability of these provisions/guidelines to CPSEs is mentioned below:

- As far as, the listed Government companies are concerned, they are required to comply with Clause 49 of the listing agreement with SEBI, provisions of the Companies Act, 1956 and also guidelines prescribed by DPE.
- The unlisted Government companies are required to comply with the DPE guidelines and provisions of the Companies Act, 1956.
- The statutory corporations established by Special Act of the Parliament are required to follow the DPE guidelines only.
- Government companies incorporated as

The major requirements of the revised Clause 49 included representation of Independent directors on the Board and Audit Committee, code of conduct for all board members and senior management, preparation of management discussion and analysis report as part of the annual report to the shareholders, certification by chief executive officer (CEO) and chief financial officer (CFO) on internal control system and separate section on corporate governance in company's annual report.



The existing legal and regulatory framework has been very well laid down, stipulating what should be the structure of the board, audit committee, their relationship and minimum number of meetings. However, recent corporate governance failures in the private sector indicate that there is need to review the same. After the corporate governance failure and consequent initiation of action against independent directors, there were large number of resignations of independent directors in the private sector.



private companies and government companies having paid up capital less than Rs. 5 crore (even when there is large amount of loan or share application money, pending allotment by the union, state or CPSEs) are required to follow DPE guidelines and provisions of the Companies Act, 1956 relating to Directors responsibility statements.

- (v) Companies where more than 51 per cent of the equity has been invested PSEs or in combination with Union and State are subject to audit at par with government companies under section 619 (B) of the Companies Act, 1956.

- However, DPE guidelines are not applicable on them as such companies are not treated as CPSEs by DPE. Thus, such companies, if incorporated as private limited companies, are not subject to corporate governance framework at all.
- Statutory Corporations and government companies, initially incorporated as private limited companies, are required to follow DPE guidelines only. However, there is absence of an institutional mechanism to oversee the compliance of DPE guidelines.

Systemic Deficiencies in the Corporate Governance Framework

The existing legal and regulatory framework has been very well laid down, stipulating what should be the structure of the board, audit committee, their relationship and minimum number of meetings. However, recent corporate governance failures in the private sector indicate that there is need to review the same. After the corporate governance failure and consequent initiation of action against independent directors, there was large number of resignations of independent directors in the private sector. Therefore, a legal framework is necessary to provide requisite protection of the Independent Director and at the same time to make them responsible, accountable, responsive and actively

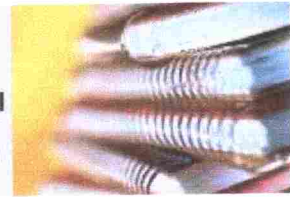
involved to understand the business activity of the company, its business environment, risk environment, its strength and weaknesses so that they can discharge their functions through active participation in the decision making process for the welfare of all stakeholders.

Based on the alleged failure of the audit to detect fraud, a debate again started that whether there should be rotation of auditors or of audit firms or no rotation. Rotation and non-rotation have their advantages and disadvantages. However, on the pattern of the CPSEs, there is a need for an independent oversight mechanism to ensure the independence and also effective functioning of the statutory auditors.

So far not much has been talked about on most of the platforms; a simple control that does not involve any cost is the "Whistle Blower policy". In all the circumstances, there would be some of the persons, who do not want to be part of the misdeeds and do not want such thing to happen, may it be window dressing of financial statements to impress the investors/market or misappropriation of assets of the company. Such whistle blowers have to be provided a platform and protection so that timely information is received for immediate corrective action.

From the corporate governance failure, we should learn lessons and take measures to avoid recurrence of such failures in future. At the same time, while introducing a new control, what needs to be considered is that cost of introduction of such a control and the fact that no legal framework can succeed, if those, responsible for exercising controls get involved in by-passing that control. A legal framework, ethical and moral values and also the 'will' by all those responsible for good corporate governance are necessary for ensuring success of corporate governance. It is understood that the Ministry of Corporate Affairs is examining some of the above issues for appropriately addressing the same in the proposed New Companies Act.

In the limited reviews undertaken by the C&AG in 2007 and 2008 to assess the compliance with the provisions of Companies Act, 1956, Clause 49 of Listing Agreement and DPE's guidelines relating to good governance in CPSEs, it was found that Out of 44 listed Central Government companies, 9 companies had no independent directors on their Board. In another 21 companies the Board did not comprise adequate number of independent directors.



Review of Corporate Governance Practices By C&AG in CPSEs

Corporate Governance translates into conducting the affairs of a company in a manner that ensures fairness to customers, employees, shareholders, fund providers, suppliers, regulators and society as a whole. The absence of good governance structure and lack of adherence to the governance principles increase the risk of public corruption and misuse of entrusted power by the management in the public sector. Considering the importance of good corporate governance in CPSEs, limited reviews were undertaken by the C&AG in 2007 and 2008 to assess the compliance with the provisions of Companies Act, 1956, Clause 49 of Listing Agreement and DPE's guidelines relating to good governance. The important deficiencies noticed in these reviews are summarised below:

- (i) Out of 44 listed Central Government companies, 9 companies had no independent directors on their Board. In another 21 companies the Board did not comprise adequate number of independent directors.
- (ii) There was no independent director in the Audit committee of 10 listed Central Government companies. In another 9 listed companies the Audit Committee did not have required number of independent directors;
- (iii) There were no non-official directors on the Board of 48 unlisted Central Government companies. In another 16 unlisted companies, the Board did not comprise required number of non-official directors.
- (iv) Five unlisted companies did not have audit committee.

[C&AG's Audit Report for the year ended March 2007, Union Government (Commercial) CA 9 of 2008]

The review of composition and functioning of Audit Committee in listed Central Government companies revealed that:

- (i) There was no independent director in the Audit Committee of 4 companies.
- (ii) The Audit Committee did not consist of required number of independent directors in 7 companies.

- (iii) Audit Committees of 9 companies were not chaired by an independent director.
- (iv) In 9 companies, there was a gap of more than four months between two Audit Committee meetings.
- (v) In 8 companies, Chairman of Audit Committee did not attend AGM of the company.
- (vi) Whistle blower mechanism did not exist in 16 companies.
- (vii) No system existed for preparation of annual report of the Audit Committee in 14 companies.
- (viii) Audit committee of 8 companies did not review anti fraud and anti-corruption policies and procedures.
- (ix) No system existed for providing training to the members of Audit Committee in 14 companies

[C&AG's Audit Report for the year ended March 2008, Union Government (Commercial) CA 22 of 2009-10]

Recommendations of Audit for Good Governance of CPSEs

The C&AG made the following recommendations to improve the corporate governance system in CPSEs in the Audit Report of 2008 and 2009-10:

- (i) As the power of appointment of directors in government companies vests with the government, clear decisions at the level of the Government on induction of sufficient number of independent directors on Board is necessary to ensure compliance with clause 49 of the listing agreement.
- (ii) Audit committee should normally promote improved systems of risk management and internal control and better financial reporting. An evaluation procedure needs to be put in place to assess the performance of the audit committee in promoting better financial reporting. Report of the Board of Directors may contain a section on self evaluation by the Audit Committee in corporate objectives, as a good professional practice.



- (iii) To promote good governance in central statutory corporations, the government may take suitable action for making it mandatory for statutory corporations to form a Board/Member level Audit committees on the lines of the listed companies.
- (iv) CPSEs should provide required training to the members of Audit Committee to enhance their financial literacy, orient them with risk profile of the business parameters of the company and thus enable them to fulfill their fiduciary responsibilities efficiently.
- (v) An annual report highlighting the improvement made in the financial reporting, internal audit, internal control functions and overall performance of the company as a result of existence and functioning of Audit Committee may be prepared and enclosed to the annual accounts.

Role of C&AG In the Corporate Governance In CPSEs

To improve the corporate governance in CPSEs, C&AG also plays an important role as could be seen from the following:

- (i) To maintain the independence of the auditors and to improve the quality of financial statements, C&AG prepares a panel of competent audit firms based on their additional qualifications, experience and size of the firms and according to the requirement of the CPSEs, appropriate single firm or firms are appointed as their statutory auditors or joint auditors depending upon the size of the CPSE. The statutory auditors are rotated periodically and are not permitted to take certain non-audit assignments.
- (ii) To oversee their functioning of the statutory auditors following steps are taken:
 - C&AG issues directions, industry/company specific sub directions to statutory auditors specifying the manner in which accounts are to be audited.
 - Conducts the supplementary audit of the financial statements of the CPSEs and reports the significant audit observations, which are not reported by the statutory auditors.
 - Evaluate the performance of statutory auditors based on the review of their

audit report as well as supplementary audit report.

- In 2009, a new methodology, three phase audit of financial statements of selected PSUs (listed CPSEs, Navratna, Miniratna-Category-I and statutory corporations) was started with a view to strengthen the system of audit, improve quality, reduce time taken for audit of financial statement and improve the interaction between the Management of the PSU, statutory auditors and Government auditors and provide opportunity to Management to take timely corrective action. The methodology has been widely appreciated by most of the CEO/CFO of the selected PSUs and their statutory auditors. Based on the response, it has been decided to extend the methodology in the current year with broadening its base to include all Miniratna CPSEs, insurance companies etc.

Conclusion

There are adequate checks and balances for ensuring good corporate governance of CPSEs; the cases of some of the non-compliances reported by C&AG through its reports and recommendations are for improving the corporate governance structure of CPSEs. Some of the corporate governance failure in the private sector highlight a need for improvement in the legal and regulatory framework besides creation of an enabling environment for adherence to ethical, moral values and will to do the welfare of all the stakeholders for a long term sustainable development of the corporate entities and those managing it.



To improve the corporate governance system in CPSEs, the C&AG has recommended in its Audit Report of 2008 and 2009-10 that as the power of appointment of directors in government companies vests with the government, clear decisions at the level of the Government on induction of sufficient number of independent directors on Board is necessary to ensure compliance with Clause 49 of the listing agreement.