Chapter-3

Corporate Governance in Government owned Entities:
The Case of Public Sector Undertakings

3.1 Introduction

Given the important place occupied by the public sector entities in the fields of industry and financial sector, any steps to improve corporate governance in the Indian economy would remain incomplete and half-hearted unless public sector units are also covered in this exercise. Therefore, in the present chapter we discuss the issue of corporate governance in public sector undertakings.

3.2 The case of Public Sector Undertakings (PSUs)

The concept of PSUs emerged in the 1950s when the country adopted the process of planning for stimulating economic development. After independence we had to develop core industries and core infrastructure for stimulating growth process in the economy. But a core industry needs huge capital, high technology skilled labour, high cost area and long gestation period which was not possible for private sector in 1947. Thus PSUs entered in the core sector and later in non-core
sector like luxury hotels and food processing. The main motives of PSUs were to attain self-reliance, increase employment, do welfare activities, check on evils of monopoly, attain economic equality, get regional equality. Most of the large public sector units established for taking up industrial and commercial activities have been set up by the central government some of the state governments like Karnataka have also set up a number of industrial and commercial units. But most of the PSUs became loss-making units after some time. The major reason behind this situation is lack of corporate governance in PSUs. Some people say that PSUs have set up to help weaker section of society or for stimulating economic development in less developed areas. Although these units are not expected to be driven by profit motives yet there is not reason why they should not be asked to adopt good corporate governance mechanism such as professional bonds, independent directors etc. On the other hand PSUs should be more responsible, more transparent because they are using public resources.

The management of a PSU has to work with a lot of directives, guidelines and almost day to day interference from the officials at various levels of the concerned administrative ministries. There are
frequent written and oral instructions by governmental agencies as to what the PSUs should or should not do. The full time directors and the CEOs of PSUs are not real in charge of their work as they are pressurized by several governmental agencies. Thus the situation of PSUs becomes worse within the passage of time.

Periodically, attempts have been made to upgrade the quality of corporate governance of PSUs. Some committees established. They gave recommendations about the upgradation of corporate governance of the PSUs in 1980s and government accepted them. The proposed changes had required that every board should have full-time directors in the fields of finance, personnel etc., and their number should not exceed one-half of the strength of the Board. The number of government directors should not exceed one-third of the Board strength while the strength of the part time or professional director should not be less than one-third of the Board strength. But the concerned administrative ministries have ignored most of the rules. Most of the PSUs became loss-making units because of gross mismanagement. In this situation any loss-making unit will be forced to close down and would not remain in continuous drag on the public resources. But the PSUs survive with
subsidy from the government in one form or other because of political compulsions and the pressures from the trade unions the concerned ministries administrative ministries avoid difficult decisions like closure or downsizing of loss-making units.

In the early 1990s, the government came up with the concept of disinvestment of PSUs by offering small stakes, entrench to financial institutions to raise resources. In 1991, the then Finance Minister, Dr. Manmohan Singh proclaimed that “In order to take resources encourage wider public participation and promote greater accountability up to 20 percent of government equity in selected PSUs would be offered to mutual funds, investment institutions and also to workers in these firms.”

When the process of disinvestment started there was a great fancy among investors to subscribe to shares of the PSUs. They thought at that time that PSUs have opened their wings. But over time the sharp fell in the prices of the PSU shares has shown that those hopes were not based on any realistic assessments. The PSUs, which face part-privatization or offer the maximum share to strategic partners, have to face the typical family controlled private sector companies’ problems. As noted already,
the family controlled managements often do not bother about the interests of the rest of the shareholders community. The PSUs of which maximum shares concerned to a big private company, board decisions do not reflect adequate concern for small share-holders. On the other hand the government retains its control over the PSUs and its public sector character is not affected. Thus the problem in regard to the quality of corporate governance not only exists in the PSUs but some of them get accentuated. As a result the confidence of market shatters ad the share prices come down. The PSUs which have not made any public issue of equity capital are also not managed in such a way that they satisfy the considerations of social equity or economic efficiency.

As a result of economic reforms, domestic deregulation and lowering trade and tariff barriers, the PSUs are finding that they will not remain viable unless they respond to market realities and growing competitions. Thus the government chose the path of shedding the government equity of PSUs for retail investors (for example in Maruty Udyog Limited) and the response was spectacular. The Maruty Udyog Limited equity offer to retail and institutional investors came good primarily because the potential investors were convinced that the
government would gradually get out. This reason behind this episode was that the investors (and in broad way the public) drew a plan to inject good corporate governance; expand production and enhance the share value.

Hence, the PSUs should be allowed to operate in a frame work that facilitates good corporate governance and build investors' confidence. The PSUs should be given high degree of internal autonomy and freedom to respond to market-forces. At present the operational freedom of the full time directors curtailed at the whim of some of administrative ministries. For example the CEOs of some of the highly profitable PSUs had to take approval of the administrative ministry before an employee of the PSU was to be sent abroad for any official business or even for training. Sometimes, the ministry approves too late to participate in that event making such approvals meaningless. The directors and the boards of the PSU do not have even the necessary powers. Most of the important matters have to be referred to the concerned administrative ministries and often the decisions are delayed. Most of the important decisions are taken either by administrative ministry or through meetings outside the boardrooms. In short the boards
are mere rubber stamp and the PSUs drive not by their CEOs but by administrative ministry.

The major reform of corporate governance in PSUs is how to make the Board fully autonomous and to make the board free day to day interference from the officials at various levels of the concerned administrative ministries. Corporate governance should be transferred back to the boards from the administrative ministries. The board should be given full autonomy and made focal point in the area of corporate governance. There should be an independent high powered selection board of eminent persons to select full time executive directors for board of the PSUs. The Selection Board should be constituted on the lines of Union Public Service Commission. The board should have all the necessary powers and should have legal authority for that. The decisions of this selection board about the appointment of full time executive directors of the boards of the PSUs should be final and the concerned administrative ministries should be formal appointing authority. The empanelment of independent or professional directors of the boards of the PSUs should be prepared by selection board. The selection board should periodically review and expand the panel of experts in different
areas for appointment as independent directors on the Boards of the PSUs. The selection board should constitute and check other board of PSU. After that any changes in these boards should be done with the help of respective committees. In short the selection board should monitor and supervise the whole work.

PSU boards should have at least four board committees, viz. audit committee, nomination committee, remuneration committee, and investment committee. The PSUs should have the freedom to determine remuneration packages for their employees including directors according to their profitability levels, size of operations and other individual criteria.

There should not be uniform pay scales which are in current practice. The remuneration packages should be adjusted upwards or downwards depending on the trends in the profitability levels. Their boards should have freedom to approve all the expansion or diversification plan if the concerned PSUs do not seek subsides or government funding. The executive and non-executive directors should owe their first allegiance to their company rather than the concerned administrative ministry. There should be the structural reform in the
constitution of boards, board committees, appointment of independent directors, transparency and full disclosures. Special attention should be given to improve quality of governance in the PSUs for which we should check the current status of corporate governance in PSUs in India.

3.3 The Current Status of Corporate Governance in PSUs

"Most of the provisions in the Companies Act regarding role/responsibility of Board also apply to the Government Companies. In addition, the Department of Public Enterprises (DPE) has specified the following:

1. Board of Directors of all non-financial PSUs should ensure that decisions regarding investment of funds are transparent and taken only by the delegated authority.

2. The activities of authority should be monitored by the Board.

3. Boards of all PSUs should lay down clear policies on investment of surplus funds, establish transparent procedures, review delegation of authority and prescribe regular reporting of investments to the Board.

4. If there is part time Chairman then he should guide the Board of Directors in the discharge of the role entrusted to them in
respect of formulating corporate policies and the corporate plan, their implementation and evaluation.

5. The part time Chairman should also evaluate the work of the Chief Executive in implementing the policies.

- The annual report on the working and affairs of each government company be prepared and laid before both the houses of Parliament along with the audit report and comments of the Controller and Auditor General of India in case the Central Government is a member of the Government Company. If the State Government is a member, the annual report has to be laid before Houses of State Legislature as well.

- There is no requirement to give full information to the non-government directors. But the part-time Chairman can call for information and this should be appropriately done through the M.D. and not directly from the officers. The agenda papers for the Board meeting are provided to all the Directors.

- At least 2/3rd of total directors should retire by rotation at Annual General Meeting. Remaining 1/3rd may be appointed or life-time or for a fixed duration.
• A retiring director may be re-appointed at Annual General Meeting.

• The appointment of M.D. or whole-time Director or Manager requires Central Government approval only in certain cases.

• The non-official Directors are appointed for three years at a time with rotational retirement. The re-appointment of Directors is possible.

• The number of Directors in Board should be up to 12. Any increase in the number of Directors beyond 12 requires Central Government approval.

• There are generally three type of Directors in a Board of PSUs i.e. Functional Directors who are full time Directors and responsible for day to day functioning of the unit; Government Directors who are appointed by the Administrative Ministries and are generally the officers dealing with particular unit; Non-Official Directors who are part time Directors of the Board.

• The concept of independence of Directors does not appear to have found its place in the existing Government guidelines.

• A person can not be on the boards of more than 15 Companies simultaneously. A full time Director can hold past only in one PSU.
• There should normally a single Chairman-cum-M. D. The post should not be vacant for very long. The officiating charge can be given to Senior Most Functional Director.

• The auditor of a government company is appointed by the Central Government on the advice of the Comptroller and Auditor General of India (CAG).

• The concept of nomination committee of the board does not exist in the Government Companies at present.

• The shareholders can participate in AGM. The notice of the AGM has to be posted to all shareholders 21 days prior to the meeting, containing the unit’s reports and accounts, the agenda.

• The shareholders who have at least \( \frac{1}{10} \)th of the paid-up share capital have the right to call an extra ordinary general meeting.

• There are no specific provisions about the evaluation of governance disclosures.

• The ordinary resolutions, such as, election and removal of directors, appointment of external auditors, remuneration of directors etc. are passed with the approval of more than 50 percent of the shareholders presence and voting.
• The special resolutions, such as, buy-back of shares, changing the name of the company etc., are passed with the approval of 75 percent of the shareholders present and voting.

• All units are required to prepare audited annual accounts which contain the balance sheet, profit and loss account, auditor’s notes on accounts and qualifications.

• Shareholders have a right to receive copies of balance sheet and auditor’s report.

• The balance sheet and profit and loss account should give true and fair view of the state of affairs of the unit.

• The units are legally bound to make timely disclosure of material and price sensitive information.

• The internal control mechanisms are not satisfactory at present.

• The Board of PSU decides the matter of annual Report.

• The interests of directors have to be disclosed periodically at least once in a year.”

The current status of Corporate Governance in PSUs is not up to the mark. To attain the social and economic efficiency, the PSUs should
improve its current status for which certain recommendations are given. The recommendations are:

3.4 Recommendations

The quality of information provided to the shareholders should be improved substantially. In particular, the balance sheet, besides meeting statutory requirements, should also devote about 6-8 pages to enlighten the shareholders about the performance of the company during the current year vis-à-vis that during the last 4-5 years. It should give a comparative picture with reference to other companies in the same/similar industry as also with reference to the industry as a whole. Consolidated accounts incorporating performance of subsidiaries and performance of various divisions of the company should be presented.

The fact that director’s duties are often followed in letter but not in spirit is all the more true in the case of Government Companies, which in many cases keeps on faithfully following extant guidelines issued by different Ministries/Departments.

Broadly speaking, the role and responsibility of the Board should be laid down in very clear terms for all kinds of government companies, just like all other companies. The recommendations made in this regard
in the context of Indian Companies should apply to the Government Companies as well. In any case, the following recommendations should apply to all listed government companies:

1. The information regarding controlling stake of major shareholders in various government companies should be publicly available.

2. The Board of Directors needs to look into improving the quality of information, which they provide to shareholders.

- The Board should be accountable to the ultimate owner of the Government Company, which is essentially public and conduct the affairs of the company in such way that the overall social and not sectional interests receive the highest priority. The company should remain viable and meet the objectives for which it has been set up. Similarly, the interests of the main stakeholders, such as employees, creditors, suppliers, customers, environmental impact of the operations of the company, etc. receive due attention.

- In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information. Information currently volunteered by the management to the board members is often quite inadequate. This needs to be improved considerably.
Whenever necessary the directors should be free to acquire, at the expense of the company, independent professional advice in regard to the matters of the company.

- The Board meeting should be conducted properly with clearly laid down agenda for discussion, which should be circulated well in advance and supported by substantive information.

- The minutes of the board meeting should be circulated well in advance of the next board meeting. This should be a mandatory recommendation for all companies.

- An independent high powered selection Board of eminent persons on the lines of the Union Public Service Commission to select full time Directors for the PSUs should be set up. Its decision should be final and not subject to approval of the concerned administrative ministry.

- The selection board should prepare a panel of experts for nomination as independent or professional Directors on the Board of PSUs.

- The induction of non-executive directors should be done by a nomination committee.

- The criteria for choosing independent non-executive directors should be disclosed in the Annual Report.
• The PSUs should have minimum of 10 board members.

• The boards of PSUs should have core group of well qualified/experienced professional non-executive directors who are truly independent.

• The definition of independence to be followed by Public Sector Companies, should be the definition recommended by the Blue Ribbon Committee in the context of the audit committees, which is as follows:

• “Members……shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.”

• In the Indian context the Directors nominated by the government on the boards of PSUs should not be considered as independent.

• A majority of non-executive directors should be independent of management and free from any business or other relationship that could interfere with their independent judgment; they should be identified in the annual report.

• Only experts, such as those having financial, technical or legal knowledge or specialization in the area of operations of the company,
should be appointed to the board. However, some training onboard practices should be imparted to the elected members at the cost of the company. For this purpose, an institute of Directors could be set up.

- In case of all PSUs, the maximum limit for a director serving on multiple boards should be 10. The same director should also not be a member of too many committees (preferably not more than 5/6 committees).

- The post of the CEO in many PSUs keeps on lying vacant for months and these undertakings are looked after by the joint secretaries of the Ministry as additional charge.

- Immediate steps should be taken to delink the posts of Chairman and CEO from the officials of the administrative ministries. Further it is also preferable to separate the role of CEO/MD from the Chairman of the Board.

- The audit committees should be comprised of a minimum of three directors, each of whom is financially literate or becomes financially literate within a reasonable period of time. Further, at least one member of the audit committee should have accounting or related financial management expertise.
• The audit committee should (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

• The audit committee charter should specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company.

• Generally Accepted Accounting Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.

• The role of Comptroller and Auditor General of India and audit committees should not be mixed up.

• Boards of PSUs should set up nomination committees consisting of at least three independent board members.
- The nomination committee should have the responsibility of purposing new nominees for the board and assessing directors on an ongoing basis. Such a review should be conducted on an annual basis so that boards are manned by persons with the appropriate skills and experience.

- The boards should be required to form remuneration committees. Remuneration committees should be made up exclusively of non-executive independent directors who make recommendations on the company's framework of remuneration for the full time directors and senior employees of the company.

- The remuneration committee should operate independently from managerial interference and from any intrusive business relationship; they should be granted full authority to seek counsel from both inside and outside sources. This should be a mandatory recommendation.

- A board committee under the Chairmanship of a non-executive director should be formed to specifically look into the redress of shareholder complaints relating to transfer of shares, non-receipt of balance sheet etc.

- The boards of PSUs should meet at least six times a year.
• Through suitable legal provisions in the Companies Act, attending of board meetings through video-conferencing facility should be recognized as valid attendance.

• The term limits for independent directors may preferably be up to 10 years in a stretch.

• All PSUs should ideally follow the maximum age limit of 65 years for whole time directors and 75 years for part time directors.

• The liability of non-executive directors should be limited. They should not be held responsible for matters that are not disclosed to the board by the executive directors. The main responsibility and liability thereof in respect of all statutory compliances should solely rest with the CEO/MD.

• The Government should lay down specific guidelines to be followed by all nominee directors such as appointment of nominee directors should be no selective basis.

• The necessary biographical details of directors should be provided in the annual report. The details should also be containing pecuniary and/or family relationships, if any, of the directors with the company and its management. All such details should be given to the
shareholders when a new director is being elected by them at the general meeting of the shareholders.

- The remuneration of executive directors should be decided by the board’s remuneration committee. Besides the usual sitting fees the non-executive directors should be suitably remunerated for the time devoted by them for the affairs of the company. There should be no upper limit for sitting fees.

- The remuneration committee should follow a clearly laid down and transparent procedure for determining remuneration to the board.

- The remuneration committee should take care to position the company among others in the industry so as not to overpay directors when no proportionate improvement in performance may be possible.

- Criteria such as performance and the company’s position among companies in the same or similar industry should factor into the determination of all incentive schemes.

- The remuneration packages of all directors should be disclosed in the annual report.

- Membership in the remuneration committee must be annually reported to shareholders.
• The annual report should include statements of shareholders regarding remuneration policy and the state of accounts.

• The report of the remuneration committee should identify directors individually and specify their compensation packages.

• Directors' total remuneration package, including share options and pension arrangements, should be subject to audit.

• The shareholders should have the final say in approving remuneration of the full time as well as the non-executive directors. The remuneration packages of senior employees holding key executive posts should be approved by the board and full details thereof should be disclosed to the shareholders.

• A system of electronic voting should be introduced to enable shareholders to vote at the Annual General Meetings (AGMs).

• Institutional investors should favour a dialogue with companies to determine mutual objectives.

• Institutional investors should encourage regular and systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management.
• Investor complaints should be brought under the purview of the Arbitration Act so that quick relief could be granted.

• The AGMs should be held at the town/city, where the CEO of the company is located/headquartered.

• The company should hold one or two general meetings of shareholders a year by rotation at different places where large number of shareholders reside so that common shareholders have opportunity to interact with the board and management of the company. The timing of such meetings should be convenient from shareholder’s point.

• Companies should make special efforts in explaining company’s governance policies, business ethics and the environment and other public policy commitments. The disclosure should help shareholders and others to evaluate the company’s statement and explanations.

• The boards of all PSUs should ensure the integrity and consistency of their reports and they should meet the financial reporting standards in letter as well as in spirit.
• There should be certain criteria for each shareholder, whether he is small or big, to get his/her voice to the board. Small shareholders should be able to get their representative elected to the board.

• All the PSUs and government owned entities should have their own website full of true information.

• All the PSUs and Government entities should give true information about unit, change in the information if any, timings of board meetings, declarations about bonus, dividend etc. to the stock exchanges, shareholders and on website as soon as possible.

• The shareholding pattern should be disclosed. There should be the clear picture of ownership whether it is complex cross-holdings across family or group controlled conglomerates or any single hold of shares.

• The accounting standards should be disclosed with related entities like, parent shareholding, information about product or service segment, information about geographical market, information about financial statements and information about partly relationships.
• All PSUs and Government owned entities should prepare and present the aggregate amount and period of defaults on repayment obligations on loans, bonds, debentures and public deposits.

• There should be an annual review of a unit in which financial, operational and compliance matters mentioned. This annual review should be a source an internal control of unit to shareholders.

• The auditors should be selected by or with the help of Audit Committee. The auditors should be independent in their work, joining and discharging from their duties.

• The audit process should be communicated throughout the unit.

• The Head of audit committee should report to board or audit committee.

• The unit should utilize the auditor's ability.

• The board should have obligation, but not accountability to stakeholders.

• The annual report of a unit should consist of internal control systems, disclosure related to management, risk management etc.

• The Director's report should be covered the compliance with government requirement.
3.5 Conclusion

Multiple layering of ‘principal-agent’ chains in the case of government owned entities has important consequences for the corporate governance mechanisms that will be adopted in them. Often the accountability chain is very weak in public sector units. The first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. The process of selecting directors should be made highly credible by entrusting the task to a specially constituted body of eminent experts with an independent and high status like the Union Public Service Commission.

The role and relationship of the administrative ministries should be limited to issuing of written guidelines/directives to units under their jurisdiction in so far as these instructions are expected to reflect the will of the ultimate owners viz. the voters as perceived by the concerned ministries. It is necessary that the rights of common shareholders should be recognized in the corporate governance mechanisms adopted by all the public sector entities. They should also adopt the system of setting
up of the four important board committees viz. the audit committee, remuneration committee, appointment committee, and investment committee. While the body of the eminent experts prepares a panel of names, the appointment committees of the public sector entities should recommend to their boards the persons from such panels that could be considered for induction on their boards.

As a matter of fact, the rights of the shareholders of PSUs stand considerably abridged. The autonomy of PSUs boards has got almost completely eroded due to special legislative provisions or notifications, day to day interference with their functioning, and issuance of detailed instructions covering every area of their operations by the concerned administrative ministries.