

CHAPTER 3

CORPORATE GOVERNANCE IN GOVERNMENT COMPANIES

3.1 Corporate Governance

Corporate Governance is a set of processes and policies affecting the way in which a company is directed, administered and controlled. Corporate Governance includes the relationships among the many players involved (the stakeholders) in the context of the goals of the company. The principal players are the shareholders, management and the Board of Directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large. The issues of accountability and fiduciary duty are important aspects of Corporate Governance essentially advocating the implementation of guidelines and Board level mechanisms to protect the interest of shareholders. Another key focus is the economic efficiency view, through which the Corporate Governance system should aim to optimize economic results, with a strong emphasis on welfare of the shareholders and social responsibility. The Corporate Governance structure spells out the rules and procedures for making decisions on corporate affairs. It provides the structure through which the company objectives are set, as well as the means of attaining and monitoring the performance of those objectives.

3.2 Brief history of Corporate Governance legislation

Important amendments introduced in the year 2000 to Sections 217 and 292 of the Companies Act (made applicable from December 13, 2000) set the tone for Corporate Governance in the country. The changes related to the following:

(i) Directors' Responsibility Statement [Section 217 (2AA)]: With a view to increasing the accountability of Directors, a company is required to include a Directors' Responsibility Statement in the Report of the Board of Directors which should affirm the following:-

- Annual accounts have been prepared in accordance with applicable accounting standards with proper explanation relating to material departures.
- The selection and application of Accounting Policies by Directors is consistent and prudent so as to give a true and fair view of the state of affairs of the company;
- Proper and sufficient care has been taken by the Directors for the maintenance of adequate accounting records for safeguarding the assets of the company and for preventing and detecting frauds and irregularities; and
- The annual accounts of the company are prepared on a going concern basis.

(ii) Formation of Audit Committee: Section 292-A of the Companies Act, 1956 requires every public limited company having paid up capital of not less than Rs.5 crore to constitute an Audit Committee at the Board level. The Audit Committee should have a minimum of three Directors and two thirds of the total number of members of Audit Committee shall be Directors other than Managing or whole time Directors. The terms of reference of the Audit Committee include all matters related to financial reporting and the audit thereof including efficacy of the internal control system.

The statutory requirement of Audit Committees brings into sharp focus the primacy of independent Directors in corporate governance and the critical role of financial reporting in satisfying the expectations of stakeholders.

3.3 Code of Corporate Governance for Listed Companies

3.3.1 The Securities and Exchange Board of India (SEBI) by its Circular dated 21 February 2000, directed Stock Exchanges to amend the Listing Agreement between them (i.e., stock exchange) and entities whose securities were listed and to include a new clause 49 in such Listing Agreement. This clause was amended in October 2004 and the revised clause has been made effective from 1 January 2006. As a result, for the year 2005-06, the revised clause 49 is applicable only for the quarter ending March 2006. Clause 49 of the Listing Agreement specifies the following, among other things:

- The CEO and the CFO have to certify the Financial Statements and the Cash Flow Statement.
- The Annual Reports of the company will have a separate section on Corporate Governance mentioning *inter alia*, the extent of compliance with the mandatory as well as the non-mandatory requirements.
- The compliance with the conditions of Corporate Governance to be certified by either the auditors or practising company secretaries.

The revised listing condition recognises the importance of financially literate and independent Directors in establishing a proper accountability regime for financial reporting. This clause also prescribes a Management Discussion and Analysis Report to form a part of the Annual Report to the shareholders, which should include discussion on industry structure and developments, opportunities and threats, risks and concerns, business outlook, internal controls, etc.

3.3.2 **Committees in Listed Companies:** Three important committees namely the Audit Committee, the Shareholders' Committee and the Remuneration Committee are expected to be formed by the listed companies in terms of clause 49 of the Listing Agreement. The Remuneration Committee determines the company's policy on specific remuneration package for executive Directors including pension rights and any compensation payments on the behalf of the Board and the Shareholders. The Shareholders' Committee is set up to redress complaints and grievances of the shareholders of the company. The remuneration of the Directors of a government company is determined by the government and as such the Remuneration Committee has negligible role in a government company. The Shareholders' Committee, however, has some role in a government company though a majority of shares are held by the Government. Audit Committee is by far the most important working committee of the Board in the case of a government company; it has an extensive role in ensuring proper financial reporting and the adequacy of internal controls over such reporting.

3.4 Constitution and functioning of Audit Committee in listed Central Government Companies

3.4.1 The role of Audit Committees in government companies is closely aligned to CAG's constitutional and statutory role in promoting fairness and transparency in financial reporting. A review was accordingly undertaken in respect of listed central government companies with the objective of assessing the compliance by these companies with various provisions of

clause 49 of the Listing Agreement relating to constitution and functioning of the Audit Committee that affect Corporate Governance and matters related thereto. The review was limited to 2005-06 and excluded two listed companies namely Bisra Stone Company Limited and Eastern Investment Limited as clause 49 is not applicable to them their paid up capital being below Rs. three crore.

3.4.2 Clause 49 of the Listing Agreement requires listed companies to have a qualified and independent Audit Committee. The requirements for Audit Committee are more rigorous in comparison to section 292A of the Companies Act, 1956 and include the following additional stipulations to regulate proper financial reporting:

- (i) The Chairman of the committee shall be an independent Director;
- (ii) The Company Secretary shall act as Secretary to the Committee.
- (iii) The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee whichever is greater, but there should be a minimum of two independent members present.
- (iv) The role of the Audit Committee is elaborate and includes the following:
 - (a) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible. .
 - (b) Reviewing with management the annual financial statements before submission to the Board, with particular reference to:
 - Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956
 - Changes, if any, in accounting policies and practices and reasons for the same
 - Major accounting entries involving estimates based on the exercise of judgment by management
 - Significant adjustments made in the financial statements arising out of audit findings
 - Compliance with listing and other legal requirements relating to financial statements
 - Disclosure of any related party transactions
 - Qualifications in the draft audit report.
 - (c) Reviewing with the management the performance of statutory and internal auditors, and the adequacy of the internal control systems.
 - (d) Discussion with internal auditors any significant findings and follow up there on.
 - (e) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.
 - (f) To look into the reasons for substantial defaults in payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
 - (g) To review the functioning of the Whistle Blower mechanism, in case the same is existing.

3.4.3 Clause 49 also prescribes a separate section on Corporate Governance in the Annual Reports of a company, with a detailed compliance report on Corporate Governance which should highlight non-compliance with any mandatory requirement along with reasons. Further, every listed company is required to obtain a certificate from either the auditors or practicing company secretaries regarding compliance with the conditions of corporate governance as stipulated in this clause and annex the same with the Directors' report.

3.4.4 A limited review of the compliance with the above aspects of clause 49 in respect of 45 listed central government companies was carried out based on Management's Compliance Report on Corporate Governance, Compliance Certificate of Statutory Auditors/Company Secretary on Corporate Governance and responses of the Statutory Auditors to the directives issued to them under Section 619(3)(a) of the Companies Act,1956. This limited review is primarily based on the information and documents obtained from the Management of the companies concerned.

3.4.5 **Formation of Audit Committee:** Though it was mandatory for Hindustan Organic & Chemicals Limited to have an Audit Committee, the same was not in existence since January 2005. In case of Bharat Heavy Electricals Ltd., there was no Audit Committee during 1 April 2005 to 6 December 2005.

3.4.6 **Terms of Reference of Audit Committee:** Clause 49 requires that the Terms of Reference of the Audit Committee should be specified. However, the same were not specified for the Audit Committee formed by Madras Fertilizers Limited.

3.4.7 **Composition and Structure of Audit Committee:** The Audit Committee should have minimum three Directors as members and two thirds of which should be independent. The following instances of non-compliance were observed in this regard:

(a) **Minimum number of Directors:** The Audit Committee formed by Hindustan Fluorocarbons Limited and Kudremukh Iron Ore Company Limited had two Directors as members as against the requirement of minimum three. The Statutory Auditors of both the companies did not report this non-compliance in their Compliance Report.

(b) **Independence of Directors:**

(i) There was no independent Director on the Audit Committee formed by the following twelve companies:

ITI Limited

MMTC Limited

State Trading Corporation of India Limited

Madras Fertilizers Limited

Fertilizer and Chemicals Travancore Limited
(from 1 January 2006 to 31 March 2006)

Balmer Lawrie & Company Limited

National Aluminum Company Limited

Andrew Yule & Company Limited

India Tourism Development Corporation Limited[∞]

Rashtriya Chemicals & Fertilizers Limited (since 30 November 2005)

Bharat Electronics Limited

Hindustan Copper Limited

(ii) In the following companies the Audit Committee did not have two thirds of its members as independent Directors:

S.No	Name of the Company	Number of Directors in Audit Committee	Number of independent Directors in Audit Committee	Percentage of independent Directors
1	Hindustan Fluorocarbons Limited	2	1	50 percent
2	Engineers India Limited	4	2	50 percent
3	Scooters India Limited	3	1	33 per cent
4	Indbank Merchant Banking Services Limited	4	2	50 per cent
5	Mahanagar Telephone Nigam Limited	3	1	33 per cent

Thus, the Audit Committee had not been constituted as per clause 49 of the Listing Agreement in the above 17 companies due to the absence of independent Directors (12 companies) and inadequate number of independent Directors (5 companies).

The Management of Indbank Merchant Banking Services Limited did not report the above non-compliance in its Compliance Report.

The Statutory Auditors of Andrew Yule Company Ltd., Hindustan Fluorocarbons Limited, Scooters India Limited, Indbank Merchant Banking Services Limited and Fertilizer and Chemicals Travancore Limited did not report the above non-compliance in their Compliance Report.

(c) **Independence of Chairman:** The Chairman of the Audit Committee should be an independent Director. As there was no independent Director on the Audit Committee in the 12 companies mentioned in Para 3(b) above, the Chairman of the Audit Committee was also not an independent Director in such companies.

3.4.8 **Working and practice of Audit Committee:** The Audit Committee was required to meet at least three times in a year till 31 December 2005 and four times in a year with effect from 1 January 2006 with a minimum gap of four months. The quorum of meeting should be either two members or one third of the members whichever is greater but there should be a minimum of two independent Directors present. This requirement was not fulfilled in the following cases:

[∞] As the accounts of India Tourism Development Corporation Limited for the year 2005-06 were in arrears, Management's Compliance Report on Corporate Governance and Compliance Certificate of Statutory Auditors/Company Secretary on Corporate Governance were not available.

(a) **Frequency of meetings:** In case of Hindustan Fluorocarbons Limited and Andrew Yule and Company Limited, Audit Committee met only once. In Hindustan Cables Ltd. the Audit Committee met only twice during the year 2005-06.

(b) **Gap between two meetings:** There was a gap of more than four months between the two meetings in case of Hindustan Cables Ltd, (6th and 7th meeting) and Kudremukh Iron & Ore Company Ltd (2nd and 3rd meeting).

(c) **Quorum of meeting:** As the minimum number of independent Directors (i.e two) required for quorum in the meeting of the Audit Committee (no independent Director in twelve companies and only one independent Director in three companies as mentioned in Para 3.4.7 (b) above) were not maintained throughout the year in 15 companies, the quorum was not attained in the meetings of the Audit Committee held during the period in which minimum number of independent Directors was less than two in these companies..

(d) **Review and discussion by Audit Committee:** In terms of clause 49 of Listing agreement, the Audit Committee should also:

- Review the annual financial statements/quarterly financial statements before submission to the board for approval.
- Review with the management the performance of internal auditors and adequacy of internal control systems
- Discuss with Statutory Auditors before the audit commences the nature and scope of audit as well as post audit discussion.

The following instances of non-compliance were noticed in this regard:

(i) In case of Andrew Yule & Company Limited, the Audit Committee did not review with the Management the annual and quarterly financial statements before submission to the Board for approval. In case of Hindustan Cables Limited, the Audit Committee did not review with the Management the quarterly financial statements before submission to the Board for approval. The Managements of both the companies and the Statutory Auditors of Andrew Yule & Company Limited did not report the above non-compliance in their Compliance Report.

(ii) In case of Mahanagar Telephone Nigam Limited, the Audit Committee did not review with the Management the performance of internal auditor and the adequacy of internal control systems and internal audit functions. Neither the Management nor the Statutory Auditors reported this non-compliance in their Compliance Report.

(iii) The Audit Committee did not have discussion with Statutory Auditors before the audit commenced about the nature and scope of audit as well as post audit discussion to ascertain any area of concern in case of India Tourism Development Corporation Limited, Scooters India Limited and HMT Limited (pre audit discussion). Neither the Management nor Statutory Auditors of Scooters India Limited reported this non-compliance in their Compliance Report.

(iv) The Statutory Auditors of ITI Limited in their Report under Section 619(3(a) of the Companies Act,1956 reported that the Audit Committee did not discuss the qualifications made in the Statutory Auditor's Report and the important comments and audit paras of Government audit as this practice was yet to be followed by the company.

3.4.9 Presence of Chairman of Audit Committee in Annual General Meeting (AGM):
As per clause 49 of Listing Agreement, Chairman of the Audit Committee should be present

in the AGM of the company. The compliance was not observed in case of Bharat Electronics Limited, Indbank Merchant Banking Services Limited, Balmer Lawrie & Company Limited, Andrew Yule & Company Limited, Hindustan Cables Ltd. and Mahanagar Telephone Nigam Limited as the Chairman of the respective Audit Committee of these companies was not present in the AGM.

The Management of Andrew Yule & Company Limited, Hindustan Cables Ltd and Indbank Merchant Banking Services Limited did not report the above non-compliance in their Annual Report. The Statutory Auditors of Balmer Lawrie & Company and Indbank Merchant Banking Services Limited did not report the above non-compliance in their Compliance Report.

3.5 Conclusions and Recommendations

3.5.1 Of the 45 listed government companies coming within the purview of clause 49 of Listing Agreement, most had generally complied with the requirements of Corporate Governance in a constructive manner. The main problem in most of the non-compliant PSUs was the absence of required number of independent Directors on their Board. This resulted in a number of instances of non-compliance with clause 49 as pointed out in the above paragraphs. Since the power of appointment of Directors vests in the Government, some clear decisions at the level of the Government on the induction of a sufficient number of independent Directors with the stipulated level of financial expertise would clearly be necessary to ensure compliance with clause 49.

3.5.2 As would be evident from the elaborate list of duties prescribed for the Audit Committee under clause 49 (Para 3.4.2 above), there is a need for putting in place better documentation procedures for recording the deliberations and decisions of the Audit Committee.

3.5.3 Corporate Governance should normally promote better financial reporting, better performance and better responses from the community of investors. An evaluation procedure needs to be put in place to assess the extent to which these corporate objectives have been achieved in the case of individual companies as a result of Corporate Governance.