

## CHAPTER 3 CORPORATE GOVERNANCE IN GOVERNMENT COMPANIES

### 3.1 Corporate Governance

**3.1.1** Corporate Governance generally refer to the practices by which organisations are directed, controlled and held to account. 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 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. It is about commitment to values, ethical business conduct and transparency. Thus, in essence, Corporate Governance translates into conducting the affairs of a company in a manner that ensures fairness to customers, employees, shareholders, fund providers, suppliers, the regulators and society as a whole.

The absence of good governance structures and lack of adherence to the governance principles increases the risk of public corruption and misuse of entrusted power by the management in public sector.

**3.1.2** The C&AG of India as the Government auditor plays an important role in effective public sector governance. The significant findings and recommendations as conveyed in the Audit Reports represent critical inputs to good governance that can lead organisations to take prompt and appropriate corrective actions to remedy identified weakness and deficiencies. The principles of accountability, transparency, probity, equity and fairness are reviewed and examined by C&AG and audit observations thereon are reported in the various Audit Reports including Reports on the performance of selected critical activities/aspects of Public Sector Undertaking with suitable recommendations.

### 3.2 Corporate Governance legislations

Important amendments introduced in the year 2000 to Sections 217 and 292 of the Companies Act, 1956 (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 292A of the Companies Act, 1956 requires every public limited company having paid up capital of not less than Rs. five 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 Committee brings into sharp focus the primacy of independent Directors in corporate governance and the critical role of financial reporting in meeting the expectations of stakeholders.

**3.3 Guidelines of Department of Public Enterprises on Corporate Governance of Central Public Sector Enterprises.**

**3.3.1** The Department of Public Enterprises (DPE) issued guideline on the composition of Board of Directors of Boards of Central Public Sector Enterprises (CPSEs) in March 1992. The guideline requires at least one-third of the Directors on the Board of a CPSE to be non official Directors. For listed CPSEs, DPE issued guideline in November 2001 on the composition of the Board of Directors. It provided 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 Securities and Exchange Board of India (SEBI) in 2000 formed a part of the this guideline.

**3.4 SEBI's Guidelines on Corporate Governance for listed Companies**

**3.4.1** 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. Clause 49 of the Listing Agreement specifies among other things, the following:

**I. Composition of the Board of Directors of listed government companies:** Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he/she is an executive director, at least half of the Board should comprise independent directors. The definition of an 'independent director' as provided in clause 49 of the Listing Agreement is given in **Appendix XV**.

**II Audit Committee in listed government companies:** A qualified and independent Audit Committee shall be set up, giving the terms of reference. The Audit Committee so set up shall have minimum three directors as members and two-thirds of the members of Audit

Committee shall be independent directors. All members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

### **3.5 Independent Directors on the Board of listed government companies**

**3.5.1** The Board is the most significant instrument of Corporate Governance. The presence of independent representatives on the Board, capable of challenging the decisions of the management, is widely considered as a means of protecting the interests of shareholders and other stakeholders.

**3.5.2** Keeping in view the importance and role of independent directors in the good governance of companies, a review was undertaken in respect of all listed government companies with the objective of assessing the compliance with the provisions of Clause 49 of the Listing Agreement relating to independent directors on the Board. This review was primarily based on the information and documents obtained from the Management of the companies concerned. The review of composition of the Board as on 30 June 2007 of all the 44 Listed government companies (excluding five deemed government companies covered by Section 619B of the Companies Act, 1956) revealed the following:

- (i) There were no independent directors on the Board of nine listed government companies given below:.

<b>S. No</b>	<b>Name of the company</b>
1	Minerals and Metals Trading Corporation Ltd.
2	State Trading Corporation Ltd.
3	Container Corporation of India Ltd.
4	Hindustan Copper Ltd.
5	National Aluminum Co. Ltd.
6	Balmer Lawrie Co. Ltd.
7	Hindustan Cables Ltd.
8	Madras Fertilizers Ltd.
9	The Fertilizers and Chemicals Travancore Ltd.

- (ii) In 21 listed government companies given in **Appendix XVI**, the Board did not have the required number of independent directors.

Thus, out of 44 listed government companies, the Board of 30 companies had not been constituted as per clause 49 of the Listing Agreement.

### **3.6 Constitution and composition of Audit Committee in listed government companies**

**3.6.1** Audit Committee is by far the most important working committee of the Board in the case of a government company with an extensive role in ensuring proper financial reporting and adequacy of internal controls over such reporting. The role of Audit Committees in government companies is closely aligned to C&AG's constitutional and statutory role in promoting fairness and transparency in financial reporting. A limited review was accordingly undertaken in respect of listed 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 composition of the Audit Committee. This review was primarily based on the information and documents obtained from the Management of the companies concerned.

**3.6.2** As required by Clause 49 of the Listing agreement, the Audit Committee should have minimum three directors as member and two thirds of which should be independent directors. As on 30 June 2007, in listed government companies revealed that an Audit Committee existed in all listed government companies. However, the following non-compliances were noticed with respect to composition of Audit Committee:

- (a) In the following seven government companies , the Audit Committee did not consist of required number of independent directors:

S. No	Name of the company	Total number of directors in Audit Committee	Status of independent directors on Audit Committee	
			Actual number of independent directors	Percentage of independent directors
1	India Tourism Development Corporation Ltd.	5	1	20 per cent
2	National Fertilizers Ltd.	4	1	25 per cent
3	Mangalore Refinery and Petrochemicals Ltd.	3	1	33 per cent
4	Hindustan Photo Films Mfg. Co. Ltd.	3	1	33 per cent
5	Dredging Corporation of India Ltd.	3	1	33 per cent
6	Hindustan Fluorocarbons Ltd.	3	1	33 per cent
7	Mahanagar Telephone Nigam Ltd.	4	1	25 per cent

- (b) There was no independent director in the Audit Committee of nine listed government companies as mentioned in para 3.5.2(i) and also in case of IRCON International Ltd.

(c) Though the Board of Bharat Immunological Biologicals Corporation Ltd. consisted of required number of independent directors, the Audit Committee did not consist of two thirds independent directors as there was only one independent director out of three directors.

(d) In case of Neyveli Lignite Corporation Limited, there was only one independent director, as on 31 March 2007, on the Audit Committee of four members. The compliance with Clause 49 of the Listing Agreement was made only on 1 June 2007 by induction of three independent directors on the Audit Committee.

(e) There was no Audit Committee during 2006-07 in case of Hindustan Organics Chemicals Ltd. However, the Committee was constituted by the Company on 28 May 2007.

Thus, the Audit Committee of 18 Central Government listed company had not been constituted as per Clause 49 of the Listing Agreement.

### 3.7 Non-official Directors on the Board of unlisted government companies

**3.7.1** The DPE's guideline on composition of Board of Directors of CPSEs issued in March, 1992 require that at least one-third of the Directors on the Board of a CPSE should consist of non official directors. A limited review was undertaken by Audit in respect of all unlisted government companies in operation with the objective of assessing the compliance by these companies with the DPE's guideline relating to non-official directors on the Board. This review was primarily based on the information and documents obtained from the Management of the companies concerned. The review of composition of the Board of unlisted companies as on 30 June 2007 revealed the following:

(i) There was no non-official director on the Board of 48 government companies given in **Appendix XVII**.

(ii) The Board of Directors of 16 unlisted government companies given in **Appendix XVIII** did not have one-third non-official directors as on 30 June 2007.

Thus, the Board of 64 unlisted government companies had not been constituted as per the Department of Public Enterprises guideline.

### 3.8 Constitution and Composition of Audit Committee in unlisted government companies

**3.8.1** As required by Section 292A of the Companies Act, 1956, every public limited company having paid up capital of not less than Rs. five crore shall constitute an Audit Committee at the Board level consisting of minimum of three directors and two thirds of which shall be directors other than Managing or whole time Directors. A limited review was undertaken with respect to constitution and composition of Audit Committee, as on 30 June 2007, in unlisted government companies in operation covered by Section 292A based on the information and documents obtained from the Management of the companies concerned, and the following instances of non-compliance were noticed:

(a) No Audit Committee was formed by the following companies:

S. No	Name of the company
1	Richardson & Cruddas (1972) Ltd.
2	HMT Machines Tools Ltd.
3	HMT Watches Ltd.
4	Spices Trading Corporation Ltd.
5	Bharat Heavy Plates & Vessels Ltd.

(b) Audit Committee formed by Indian Renewable Energy Development Agency Ltd. consisted of two directors as against the requirement of minimum three. Further, the Committee did not consist of two thirds of directors as directors other than Managing or whole-time directors as there was only one such director.

### **3.9 Constitution of Audit Committee by unlisted government companies not covered by Section 292A of the Companies Act, 1956**

**3.9.1** Thirty unlisted government companies given in **Appendix XIX** had formed Audit Committees as good governance practice, though these were not required to do so as per Section 292A of the Companies Act, 1956.

### **3.10 Corporate governance in statutory corporations**

**3.10.1** The Government has also established statutory corporations like Food Corporation of India, Airports Authority of India, National Highways Authority of India and Central Warehousing Corporation by special Acts of the Parliament. The Government by making amendments in the Companies Act, 1956 in 2000 has prescribed good corporate governance practices with a view to promote more transparent, ethical and fair business by all corporate entities. Such good governance prescriptions are a recent development and as such the governing legislations of statutory corporations do not contain provisions relating to the constitution of Audit Committees and preparation of Directors/Members' Responsibility Statement. Consequently these corporations do not prepare Directors'/Members Responsibility Statement despite substantial public money being involved in them. The Department of Public Enterprises through its guidelines of June 2007 requires all Central Public Sector Enterprises (CPSE) to adopt good governance practices. There is however ambiguity regarding Central Statutory Corporations coming within the definition of CPSE, which needs to be suitably clarified.

### **3.11 Reference to Department of Public Enterprises by Audit**

**3.11.1** Since the main problem observed in most of the non-compliant Government companies was the absence of required number of independent directors or non-official directors on their Boards, the matter was referred to DPE in October 2007 indicating the need for the Government to take suitable steps for the induction of independent or non-official directors on the Board of deficient government companies. No response from Department of Public Enterprises was received (December 2007).

### **3.12 Conclusions and recommendations**

**3.12.1** The major weakness in CPSEs was absence of required number of independent directors on the Board of listed government companies and the non-official directors on the Board of unlisted government companies. The absence of independent directors resulted in a number of other instances of non-compliance with clause 49 relating to non-existence of independent directors in the Audit Committee, independence of the Chairman of Audit Committee and requirement of quorum of meeting of Audit Committee. 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 or non-official directors on the Board is necessary to ensure compliance with clause 49 by the listed government companies and with the Department of Public Enterprises guidelines by unlisted government companies.

**3.12.2** Audit Committees 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. Annual Report of the Board of Directors may contain a section on self evaluation by the Audit Committee in promoting corporate objectives, as a good professional practice.

**3.12.3** In order 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/Members level Audit Committee; and for the positive assertion of the responsibility of Directors'/Members' on the lines of the provisions of the Companies Act, 1956. This is likely to strengthen accountability and commitment of the higher levels of Management towards better systems of risk management and internal controls.