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Corporate Governance of Public Sector Enterprises in India

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Abstract

Since the financial crisis of 2007–08, the world has witnessed a renaissance of state capitalism. The rise of state capitalism constitutes one of the biggest changes in the world economy today. Its growth has given rise to a range of challenges for governments and regulators. In State-owned Enterprises (SOEs),[1] government control presents inherent governance challenges that contribute to poor performance. Consequently, corporate governance of SOEs remains a major challenge in many economies. In India too, the government owns or controls interests in key sectors, including infrastructure, oil, gas, mining, and manufacturing. Over the decades, the Government of India (GoI) has taken a number of steps to improve the performance of Central Public Sector Enterprises (CPSEs), including through better corporate governance. Governance reforms have gained prominence because of the important role that CPSEs continue to play in the Indian economy; the increased pressure on CPSEs to improve their competitiveness; and the listing of CPSEs on the stock exchanges. This article looks at the current corporate governance regime for CPSEs in India and the corporate governance challenges faced by CPSEs. It measures up the current governance practices of CPSEs against the OECD Guidelines on Corporate Governance of SOEs. It also looks at how government's recent measures negatively affect the CPSE oversight structure, rights of minority shareholders, ownership structure of CPSEs, board functioning, and risk management.

This article looks at the current corporate governance regime for CPSEs in India and the corporate governance challenges faced by CPSEs. It measures up the current governance practices of CPSEs against the OECD Guidelines on Corporate Governance of SOEs.

I. Introduction

Since the financial crisis of 2007–08, the world has witnessed a renaissance of state capitalism.[2] The financial crisis required a number

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[1] A *List of Abbreviations* is presented at the end of this article.

[2] State capitalism tries to meld the powers of the state with the powers of

of governments to provide capital support to distressed enterprises and financial institutions. Prior to this, state-owned enterprises (SOEs) from large emerging countries had grown strongly and integrated more closely with the international economic system. They became wealthier and more powerful even as the overall state sector in those countries was shrinking. SOEs the world over are now playing a significant role not only in their respective national economies, but also in the international economy. They employ millions of people and are concentrated in strategic sectors that determine the competitiveness of the private sector.

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The rise of state capitalism constitutes one of the biggest changes in the world economy in the modern era. Its growth has given rise to a range of challenges for governments and regulators. Their concerns are related to national security, maintenance of competitive markets, regulation and efficiency of SOE operations. The specific challenges of SOE governance have been the principal-agent problem, lack of proper oversight, political interference, weak and disorganised boards, and a confused mix of commercial and social objectives that SOEs must achieve. Consequently, corporate governance of SOEs is a major challenge in many economies. Proper implementation of corporate governance helps countries manage more effectively their responsibilities as company owners, thus helping to make SOEs more competitive, efficient, professional, and transparent, besides allowing the creation of a level playing field for the private sector. But efforts to improve corporate governance in SOEs have lagged those of the private sector.

In India, the government owns or controls interests in key sectors with significant economic impact, including infrastructure, oil, gas, mining, and manufacturing. Over the decades, the Government of India (GoI) has taken a number of steps to improve the performance of Central Public Sector Enterprises (CPSEs), including through better corporate governance. Reforms during the 1990s focused on liberalisation and deregulation of most sectors, disinvestment of government shares, grant of greater autonomy through delegation of decision-making powers to leading companies, and development of a performance monitoring system to ensure accountability. These and other steps to strengthen CPSE boards and enhance transparency evolved into a more comprehensive governance approach, culminating in the Guidelines on Corporate Governance of State-Owned Enterprises issued in 2007 and their mandatory implementation from 2010 onwards. Governance reforms gained prominence for several reasons: the important role that CPSEs continue to play in the Indian economy;

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capitalism. It depends on government to pick winners and promote economic growth. But it also uses capitalist tools such as listing state-owned companies on the stock market and embracing globalisation. State capitalism also includes managing huge pools of capital in the form of sovereign wealth funds.

increased pressure on CPSEs to improve their competitiveness as a result of exposure to competition and hard budget constraints; and listing of CPSEs on the capital markets (World Bank, 2010).

This article looks at the current corporate governance regime for SOEs in India and the corporate governance challenges faced by SOEs. The article measures up the current governance practices of SOEs against the OECD Guidelines on Corporate Governance of State Owned Enterprises, which are an international benchmark.

The structure of the article is as follows: section II highlights the importance of corporate governance in SOEs, section III describes the significance of public sector enterprises in India, section IV describes the current governance practices in CPSEs, section V highlights the challenges that CPSEs face in reforming their corporate governance regime, and section VI concludes.

II. Importance of Corporate Governance in SOEs

a. Principal-Agent Issues in SOEs

In any economic organisation, exchange between three main actors, viz. workers, managers and owners, is characterised by a series of contracts where one party, the agent, agrees to perform tasks on behalf of the principal in return for compensation. SOEs can be specifically perceived from the point of view of principal-agent relationships of citizens, politicians, senior bureaucrats, subordinate bureaucrats and managers. If the principal, i.e. government, possessed full information about market and technological conditions, it could instruct the agent to set first-best levels of prices, output, capital, labour and wage rates. If allocative efficiency were the concern then this would imply marginal cost pricing, labour receiving its opportunity cost wage, and inputs chosen to minimise costs. Government or for that matter any other principal does not effectively possess all the relevant information. However, at the enterprise level, the relevant information can be sought through expensive trial and error.

In market economies, most state institutions are formed to provide public goods, or goods and services that have strong externalities. Their principal goal may not be maximisation of profits or net worth, but some complex set of objectives, which cannot be readily measured in financial terms. Given the political compulsions and other economic considerations, agency costs are a manifestation of the difference in the firm's value when the firm is compelled to opt for the second best operating policy rather than the first best (Som, 2006).

The identity of owners in SOEs is fuzzy. While in theory these firms are owned by the public at large, the *de facto* control rights belong to bureaucrats. These bureaucrats have concentrated control rights, but no significant cash flow rights because cash flow ownership of SOEs is in theory effectively dispersed amongst the taxpayers of the country. Bureaucrats have goals that are dictated by political interests.

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Particularly in democratic countries these executives operate under many constraints of running SOEs in ways that will be acceptable to the relevant population or their representatives.

The other specific characteristic of SOEs, given the lack of effective monitoring to control agency costs and lack of competition, is that the planner-manager relation has developed in an idiosyncratic and inefficient way. SOE managers have to operate within relatively narrow constraints. There is no automatic and constantly operating economic feedback mechanism that controls the performance of managers and planners (Wagener, 1996). Managers of SOEs may engage in practices that are difficult to verify; and the penalties that can be imposed on SOE managers when failure occurs are limited. The severity of the agency problems encountered by the government is compounded by the government's relative imperviousness to financial distress (Brealey *et al*, 1997). The lack of avenues for comparisons of efficiency makes it difficult to ascertain whether production in SOEs is efficient or not. All these features of SOEs make it difficult for them to perform as profitable companies.

Avoiding agency related costs requires that the state find a balance between its responsibility for actively exercising its ownership functions and refraining from undue political interference in the management of the company, a level-playing field in markets where private sector companies can compete with SOEs, and a strict separation of the state's ownership and regulatory functions. Implementation of corporate governance regimes helps overcome the structural features of SOE functioning, and ensures that governments do not distort competition in the way they use their regulatory or supervisory powers, thereby aiding in their better performance.

In virtually all industrialised and emerging economies, the share of SOEs decreased in the decade leading up to 2008. Partial divestment by governments has reduced their holdings to a significant extent, but governments continue to hold non-trivial and often controlling stakes in SOEs.

b. SOEs' Contribution to the Economy

SOEs the world over remain significant despite decades of privatisation. They employ millions of people and are increasingly concentrated in a few strategic sectors in which they determine the competitiveness of the private sector. The financial crisis of 2008 forced a number of governments to provide capital support to distressed enterprises and financial institutions. Government intervention was necessary to avoid systemic risk and to maintain confidence in the system.

SOEs account for around 5 per cent of the total economy (measured by output, value added or employment) of an average OECD country. In the largest emerging economies, the share of SOEs is between 10 and 40 per cent. The largest concentration of SOEs is found in public utilities, telecommunications, banking, hydrocarbons and extractive sectors. In virtually all industrialised and emerging economies, the share of SOEs decreased in the decade leading up to 2008. Partial divestment by governments has reduced their holdings to a significant extent, but governments continue to hold non-trivial and often controlling stakes in SOEs. Governments' ability to wield influence has not receded as decisively as the drop in the SOEs' share in the economy. To raise efficiency in SOEs and to ensure that tax payers' money is well spent, a corporate governance regime is important.

It has become clear that for both political and economic reasons, the state will remain a major owner of productive assets in a number of economies for years to come. Temporary government ownership/control of private sector enterprises has added to the existing corporate governance challenges. Governments are now concerned about maintaining a level playing field, ensuring efficiency in the use of public money and paving the way for an orderly exit. Implementation of corporate governance guidelines would help in assuaging some of those concerns.

c. Geopolitical Concerns

SOEs in the resource based industries and public utilities have been at the forefront of internationalisation in OECD as well as non-OECD countries. There are regulatory and political concerns that may arise from the cross-border operations of SOEs. They include: (1) political unease about the motivations underpinning actions of companies controlled by foreign governments; (2) perceptions of privately owned businesses that there is no level playing field for SOEs and others, for example, because of government subsidies, or preferential access to finance; (3) labour groups' concerns that foreign SOEs threaten domestic jobs because they benefit from "unfair" advantages; and (4) public controversy when foreign SOEs invest in sectors that have been previously privatised. Having a corporate governance regime is useful to governments that own SOEs operating abroad in addressing host country concerns, as well as to regulators and policymakers in gauging the intentions and likely impacts of foreign SOEs' operations in the domestic economy (OECD, 2010).

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III. SOEs in India and their Importance

Central and state public sector enterprises have long played a prominent role in India's industrialisation and economic development. At Independence, India was predominantly an agrarian economy, with a weak industrial base, low savings, insufficient investment in infrastructure and poor industrial facilities. PSEs were therefore created as vehicles for industrial and regional development, basic infrastructure networks, and employment generation. A large number of CPSEs were initially set up as green field projects. Others, mainly sick companies, were taken over from the private sector. The macroeconomic objectives of CPSEs have been derived from the Industrial Policy Resolutions and the Five Year Plans. State-level PSEs were established because of the rising need for public utilities in the states.

The evolution of PSEs in India can be divided into three distinct phases: (1) The pre-Independence era; (2) The post-

Independence era; and (3) The post-liberalisation period. During the pre-Independence era, there were few public enterprises, namely, the railways, the posts and telegraph, the port trust, All India Radio, and the ordnance factories, among some other government managed enterprises. During the post-Independence era, the Industrial Policy Resolution 1956 was implemented. It called for CPSEs to be given greater autonomy and be organised on business lines. In 1965, the Bureau of Public Enterprises, later the Department of Public Enterprises (DPE), was established to report on CPSE performance. And in the mid-1980s the Memorandum of Understanding (MoU) system was introduced to increase enterprise accountability. The post-liberalisation era, which commenced in 1991, saw the Government introducing the concept of Maharatna, Navratna and Miniratna to accord greater financial and managerial autonomy with the aim of incurring higher capital expenditure. The New Industrial Policy of 1991 expanded the reforms of the previous decades. It highlighted the need for CPSEs to innovate and lead in areas of "strategic" importance. To raise resources and encourage public participation, the policy also called for the partial sale of shares of CPSEs and other SOEs to financial institutions and the public through the disinvestment programme. Boards were to become more professional, and emphasis was placed on the MoU system to give managers greater autonomy while holding them accountable. The policy called for the restructuring of poorly performing or sick enterprises while developing social security mechanisms to protect affected workers. To further advance the governance efforts, in July 2007, the DPE issued the Guidelines on Corporate Governance for CPSEs. Patterned on Clause 49, the Guidelines aim to improve board practices and other elements of corporate governance in all CPSEs, including non-listed enterprises (Dun and Bradstreet Report, 2011). These guidelines have become mandatory for all PSEs since 2010.

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CPSEs remain important contributors to the economy. Through CPSEs, the government owns or controls large interests in key sectors with significant economic impact, including infrastructure, oil, gas and mining, and manufacturing. CPSEs continue to hold control across several industries, despite the opening up of several sectors for private investment. CPSEs continue to have complete monopoly in nuclear power generation. Other leading areas of dominance are coal (over 80 per cent), crude oil (over 70 per cent), refineries (over 55 per cent) and wired lines (over 80 per cent). PSEs in India have grown from only five enterprises in 1951 to 248 in 2011. The share of gross value addition of CPSEs in GDP at market prices was 6 per cent in 2010–11. The share of CPSEs in the manufacturing sector in terms of gross block was the highest with 27.8 per cent, followed by electricity with 25.2 per cent, services with 23.2 per cent and mining with 23 per cent. CPSEs account for around 6 per cent of the total employment in the organised sector in India.

CPSEs are listed on the Bombay Stock Exchange and they account for around 22 per cent of the market capitalisation. Apart from fulfilling social commitments, PSEs contribute significantly to the Central Exchequer through direct taxes and dividend. The Central Exchequer derives income from CPSEs through two main sources, namely, investments in the CPSEs and returns in the form of dividend and interest and through various taxes and duties levied. The total value of contribution from CPSEs to the Central Exchequer registered a 1.2 per cent compounded annual growth rate (CAGR) during 2006–07 to 2010–11. A major proportion of the revenue to the Central Exchequer is through various taxes and duties. Excise duties and corporate taxes on an average accounted for around 40 per cent and 25 per cent of the total contribution to the Central Exchequer respectively, during the five-year period of 2006–07 to 2010–11. During the same period, corporate tax and dividend tax were the fastest-growing sources that registered 7 per cent CAGR each (Dun and Bradstreet, 2012 and DPE). *Table 1* shows that CPSEs' contribution to GDP and employment is decreasing over the years. Yet their contribution to the Central Exchequer, their foreign exchange earnings, and their net profits have all shown a steady rise.

TABLE 1
Performance of SOEs

Year	*No. of Operating SOEs*	*Capital Employed (Rs. cr.)*	*Share of SOEs to GDP (mkt prices)*	*Employment (nos.)*	*Market Capitalisation of SOEs*	*Contribution to Exchequer (Rs. cr.) – taxes, dividends and interest*	*Dividends (Rs. cr.)*	*Forex Earnings (Rs. cr.)*	*Net Profits (Rs. cr.)*
2004–05	227	504407	11.68%	1693000	18.35%	110599	20718	42264	63889
2005–06	226	585484	11.12%	1694000	21.64%	125384	22886	45954	66344
2006–07	217	661338	8.66%	1614000	18.36%	147635	26819	65620	77175
2007–08	214	724009	8.02%	1565000	21.8%	165994	28123	67678	79704
2008–09	213	792232	6.49%	1533000	26.3%	151543	25501	74184	69267
2009–10	217	908007	6.44%	1490000	23.13%	139918	33223	84224	83939
2010–11	220	949499	5.96%	1444000	22.03%	156124	35681	97004	86324

Source: DPE, PE Survey 2011-12.

IV. Current Corporate Governance Regime for CPSEs

Corporate governance has been an important part of GoI's broader CPSE and economic reforms, aimed at improving the performance and competitiveness of some of India's most important national assets, allowing companies easier access to the capital markets, and making companies more transparent and accountable. These reforms were undertaken to move away from day-to-day management of CPSEs towards exercising its shareholder rights based on corporate governance principles. The governance framework for

CPSEs is consistent with several aspects of international good practices. Reforms since the early 1990s have ensured that CPSEs face direct competition from the private sector, direct budgetary support to firms has been reduced, GoI shareholding in the companies has been lowered through stock market listing, legal distinction between CPSEs and private sector companies has been gradually eroded, and procurement preferences that favoured CPSEs once have been completely done away with.

CPSEs are governed by a complex legal and institutional framework. They are mainly governed by the Companies Act, Clause 49 of the Listing Agreement, and DPE guidelines. In addition, CPSEs are subject to various other laws and regulations. Institutional arrangements for exercising the state's ownership rights are complex compared with international practice. GoI shareholding in CPSEs is held by the President of India, *ex officio*. The President's powers as a shareholder are delegated to 38 administrative ministries, each with its own portfolio of CPSEs. DPE serves as the nodal agency. The following table provides information about the current governance practices in CPSEs. The DPE guidelines are too narrow in scope and are silent on many of the OECD guidelines and sub-guidelines that now act as an international benchmark.

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TABLE 2
Current Governance Practices in CPSEs

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
I. **Ensuring an Effective Legal and Regulatory Framework for SOEs**	
a. There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.	There are several regulatory authorities over-seeing CPSEs: SEBI, which enforces securities rules for listed CPSEs; Ministry of Company Affairs (MCA), which oversees compliance with the Companies Act; regulators in the telecom, petroleum and electricity sectors, which regulate pricing and other sector specific issues for the relevant CPSEs; and Competition Commission of India (CCI).
b. Governments should strive to simplify and streamline the operational practices and the legal form under which SOEs operate.	Legal forms of PSEs are Government Companies, Public Corporations, Departmental Enterprises, Trusts, and state-owned banks. Legal distinctions between CPSEs and private sector companies have been gradually eroded.
c. Any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations.	Twenty-five CPSEs, including public corporations and those incorporated under Section 25 of the Companies Act (CA), are explicitly charged with implementing GoI programmes in specific sectors or servicing specific GoI departments and thus do not operate on strict commercial lines. But CPSEs incorporated as companies may have social or

TABLE 2: ***contd/-***

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	policy obligations that are, as per DPE guidelines, specified in the memorandum of association or in the company statute. Some social responsibilities may also be assigned through Presidential directives or orders by the administrative ministry. These can be opaque and informal or non-explicit in nature, and decided in an *ad hoc* manner.
d. SOEs should not be exempt from the application of general laws and regulations.	CPSEs generally fall under the same legal framework as the private sector, although some laws contain special provisions or exemptions for state-owned companies. CPSEs fall under the definition of "State" as provided in Article 12 of the Constitution of India. CPSEs are governed by the Companies Act, 1956, securities regulation and regulations of various authorities like the Comptroller and Auditor General of India (C&AG), Central Vigilance Commission, administrative ministries, and other nodal ministries. The Right to Information Act 2005, labour laws, insolvency laws and the Competition Act 2002 are all applicable to CPSEs.
e. The legal and regulatory framework should allow sufficient flexibility for adjustments in the capital structure of SOEs when this is necessary for achieving company objectives.	A "National Investment Fund" was set up in 2005 into which proceeds from disinvestment of government equity in CPSEs are channelled. Twenty-five per cent of the fund is allocated to meet the capital investment requirements of profitable and revivable CPSEs. The 1997 DPE guidelines gave large and important companies special status and greater functional autonomy in decisions about investments, capital expenditures, joint ventures, mergers and acquisitions, and in raising debt from capital markets.
f. SOEs should face competitive conditions regarding access to finance.	CPSEs increasingly turn to capital markets to mobilise resources, as budgetary support to CPSEs has declined. However, public sector banks remain major lenders to CPSEs, which in turn can borrow more easily from state banks than other companies as banks may have higher comfort in lending to companies that are state-owned. CPSE borrowings are still explicitly guaranteed by GoI, while GoI also provides both loans and equity finance through administrative ministries.
II. **State Acting as Owner**	
a. The government should develop and issue an ownership policy that defines the overall objectives of state ownership.	The Industrial Policy Resolution of 1956 has been the guiding factor, which gave the public sector a strategic role in the economy. The "Statement on Industrial Policy" of 1991 also

TABLE 2: ***contd/-***

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	included a Statement on Public Sector Policy. Yet there is no specific state ownership policy document.
b. The government should not be involved in the day-to-day management of SOEs and allow them full operational autonomy to achieve their defined objectives.	The predominant view suggests that, at present, there is heavy overregulation of CPSEs through the involvement of administrative ministries in day-to-day matters and through other checks and balances, which together constrain the companies and minimise entrepreneurial or commercial decision-making. Such interventions are less in the case of Navratnas and Miniratnas, which have been delegated significant decision-making powers.
c. The state should let SOE boards exercise their responsibilities and respect their independence.	The DPE guidelines on the composition of the board of CPSEs require that the board of the company should have an optimum combination of functional, nominee and independent directors. For Navratna and Miniratna (created to increase the financial and operational autonomy of the country's top performing public enterprises) CPSEs, the guidelines require that their boards be professionalised by adequate number of non-official directors, with minimum four in the case of Navratnas and minimum three in the case of Miniratnas. But boards especially in Navratnas and Miniratnas could be made more effective by bringing in independent directors from the private sector, and empowering the boards with greater decision-making authority.
d. The exercise of ownership rights should be clearly identified within the state administration. This may be facilitated by setting up a co-ordinating entity or, more appropriately, by the centralisation of the ownership function.	India's approach to organising the state's ownership arrangements is closer to the dual model, reflecting its political system of checks and balances, a strong administrative and institutional culture, and a large and diverse state enterprise portfolio. State's ownership rights are delegated to the administrative ministries, while DPE serves as a nodal agency for preparing guidelines, facilitating the MoU process and serving as a source of information to Parliament and the public. In addition, other agencies play important roles: investment decisions may have to be approved by PIB and Cabinet, which also approves certain board level appointments; CAG appoints the auditor and also conducts various additional audits; CVC oversees the conduct of CPSE employees and has related powers; and bodies such as the Public Enterprise Selection Board (PESB) and the Board for Reconstruction of Public Sector Enterprise (BRPSE) provide advice on various matters.

TABLE 2: ***contd/-***

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
e. The co-ordinating or ownership entity should be held accountable to representative bodies such as Parliament and have clearly defined relationships with the relevant public bodies, including the state supreme audit institutions.	As the main oversight body, a number of parliamentary committees routinely review CPSE performance and related issues.
f. The state as an active owner should exercise its ownership rights according to the legal structure of each company.	India has a well-established process for appointing the different categories of directors. As per the provisions of DPE guidelines and Clause 49, boards typically consist of a full-time Chairman-cum-Managing Director (CMD) and three categories of directors: government directors, functional directors, and independent directors. In all companies, government directors are appointed by the minister concerned. For the other two categories, the appointment process is complex, varying by category of director and by type of CPSE. Functional directors are short-listed (based on predetermined eligibility criteria) by the PESB and interviewed by the PESB board in consultation with the secretary concerned and CEO of the company. The shortlist is sent to the ministry and to CVC for vigilance clearance. For the more important companies, the final selection is made by the Appointments Committee of Cabinet (ACC). For independent directors, the ministry concerned proposes the names of three candidates to the PESB, drawing from the DPE databank of candidates. For Navratnas and Miniratnas, the selection is made by a Search Committee chaired by the PESB chairman and consisting of the DPE secretary, the secretary of the ministry concerned, the CEO of the company concerned, and four non-official members. The board appointment process is relatively independent and professional compared with the processes of many other countries. But boards still lack the requisite number of independent directors. India has one of the more sophisticated state enterprise performance monitoring systems in place. CPSEs are monitored and evaluated through the MoU process, which is an annual performance agreement negotiated and signed between the CPSE and the administrative ministry.
III. **Equitable Treatment of Shareholders**	The listed CPSEs have large numbers of minority shareholders, some more than 100,000 each. These shareholders are protected by the relevant provisions in the CA and SEBI regulation, including disclosure

TABLE 2: ***contd/-***

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	requirements, the right to receive notice of and participate in the general shareholders meeting, and transfer their shares and receive dividends. But the special status of CPSEs limits the role that outside investors play in the governance of the company. DPE guidelines and 51+ per cent state ownership ensure that key decisions, including board selection and major transactions, are made by GoI or the directors. In many cases, direct and indirect state ownership is greater than 76 per cent, so that changes to the articles and other decisions requiring qualified majorities can be made without the consent of other shareholders. Special provisions in the CA for government companies further limit non-state shareholders and reinforce the role of the GoI.
IV. **Relations with Stakeholders**	DPE guidelines are silent on relations with stakeholders.
V. **Transparency and Disclosure**	
a. The co-ordinating or ownership entity should develop consistent and aggregate reporting on SOEs and publish annually an aggregate report on them.	Overall, India provides a level of disclosure comparable with that of the more advanced OECD economies. At the aggregate level, both CAG and DPE submit comprehensive annual performance reports to Parliament and the public. The former contains information on government loans and equity, market capitalisation of listed companies, returns on investment, profits and dividends, and net worth, and accumulated losses. It also includes qualifications from external audits, the findings of various CAG audits, and special topics like environmental and sustainability reporting. The DPE report focuses mainly on CPSEs. It presents data on investment, revenue, profitability, and contributions to the budget and foreign exchange. Information is also provided on productivity, research and development, and GoI policy areas such as the MoU system, delegation of powers, human resources, privatisation and restructuring. The RTI Act, which covers the transparency and accountability of the public sector, requires administrative ministries to disclose a range of information about CPSEs on their websites.
b. SOEs should develop efficient internal audit procedures and establish an internal audit function.	CPSEs have a three tier audit system, including: (i) statutory audit; (ii) CAG audit; and (iii) internal audit. CPSEs are required to have audit committees that oversee the disclosure process, internal audit, risk management, and internal controls. Under the CA, the work of the internal auditors is also reviewed by the statutory auditors as part of

TABLE 2: *contd/-*

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	the statutory audit. Clause 49 requires management in listed CPSEs to certify that internal controls have been established and evaluated and disclosed to the board on a regular basis. Large CPSEs and other major listed companies have advanced systems and in some cases are SAP compliant with integrated risk management systems in place, but for the vast majority of CPSEs the internal control function appears to be in its early stage.
c. SOEs, especially large ones, should be subject to an annual independent external audit based on international standards.	CAG appoints the statutory auditors and directs how the statutory audit is carried out. Auditors are selected from a panel of firms maintained by CAG on the basis of experience and size of the audit assignment. It seeks to ensure the independence of the audit by following the criteria in the CA and Chartered Accountants Act 1949, which limit the appointment of an auditor otherwise connected to the company or its success. CAG has imposed two additional requirements to maintain auditor independence: restricting the acceptance of non-audit assignments by the auditors, and providing for rotation of the audit firm every four years.
d. SOEs should be subject to the same high quality accounting and auditing standards as listed companies.	At the company level, various laws, regulations, and guidelines govern disclosure of financial and non-financial information, including the CA, Clause 49, various DPE guidelines, CAG guidelines, Accounting Standards, and the CG guidelines for CPSEs. Like other Indian companies, financial statements are prepared using the format prescribed in the CA and in compliance with the Indian Accounting Standards (IAS) issued by The Institute of Chartered Accountants of India (ICAI). The ICAI has sought to bring IAS closer to International Financial Reporting Standards (IFRS), and many standards have international equivalents, although certain differences remain.
e. SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public.	The great majority of CPSEs meet basic filing requirements. Listed CPSEs provide a high level of disclosure of financial and non-financial information, consistent with securities regulation. Many non-listed CPSEs also disclose a range of information via their websites. But disclosure is not always in conformity with the CG guidelines or other requirements. The level and quality of information vary across companies; in some cases, the information may be outdated. Key material information is also rarely disclosed by

TABLE 2: ***contd/-***

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	CPSEs. This includes most related party transactions, non-commercial objectives, social obligations, ministerial requests or directions, and MoU targets or target areas.
VI. **Responsibilities of the Boards of SOEs**	
a. The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.	The DPE guidelines require that there is a clear definition of the roles and the division of responsibilities between the board and the management. The board should have a formal statement of Board Charter, which clearly defines the roles and responsibilities of the board and individual directors. The board of each CPSE may be encouraged to articulate its objectives and approach to satisfy the expectations of its majority shareholders and other stakeholders.
b. SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity. They should have the power to appoint and remove the CEO.	Delegation of decision-making powers through DPE guidelines has helped empower the boards of CPSEs, particularly of Navratna and Miniratna companies. In practice, however, anecdotal evidence and stakeholder discussions suggest that there are several areas where CPSE boards have little or no say. Such areas include appointment and removal of the CEO and directors, and to a lesser extent, strategy formulation, both being legitimate and fundamental board functions. Another such area is day-to-day commercial decision-making. Except for investments, government is said to intervene in most matters.
c. The boards of SOEs should be so composed that they can exercise objective and independent judgement. Good practice calls for the Chair to be separate from the CEO.	The most common practice among CPSEs is to have an Executive Chairman with the designation of Chairman-cum-Managing Director (CMD). Nearly two-thirds of the CPSEs have a CMD, while the remaining third have a part-time chairman with a separate full-time MD.
d. When necessary, SOE boards should set up specialised committees to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration.	The role of the audit committee is well recognised in the CPSE governance framework. Listed companies are required to set up an audit committee whose status, composition and responsibility are defined as per Clause 49. The audit committee is also mandated by the Companies Act in the case of public companies with prescribed paid-up capital not less than Rs. 5 crore. DPE's CG guidelines also require unlisted companies to set up an independent and qualified audit committee, and spell out their role and powers in detail. Statutory corporations do not have provisions for constituting audit committees, but may establish advisory committees as seen fit. DPE guidelines also require that CPSEs

TABLE 2: *contd/-*

OECD Guidelines on Corporate Governance of SOEs	Current Practice in India
	constitute a remuneration committee comprising at least three directors, all of whom should be part-time directors (i.e. nominee directors or independent directors). The committee decides on annual bonus/ variable pay pool.
e. SOE boards should carry out an annual evaluation to appraise their performance.	There is also no systematic process for evaluating CPSE boards and board evaluations are rare. Performance of directors is reviewed by the administrative ministries at the end of the first year before confirming the remaining part of the tenure. A board member who fails to perform satisfactorily in the performance review can be removed by GoI. There is no system for evaluating the performance of full-time directors or of independent directors. However, Clause 49 in its non-mandatory requirements provides for the evaluation of non-executive directors by a peer group comprising the entire board of directors, excluding the directors being evaluated.
Sources: DPE PE Survey 2011-12, OECD (2005), World Bank (2010).	

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V. Corporate Governance Challenges facing CPSEs

In SOEs, state ownership and government control present inherent governance challenges that contribute to poor performance. The focus of SOE reform has been on privatisation, which remains the most direct solution to the problems of state ownership. But there is a widespread recognition in India that corporate governance regime is important for CPSEs and of what needs to be done to improve CPSE corporate governance further. Numerous commissions and expert groups have studied the issues in depth and offered recommendations for improvement. The challenge therefore, going forward, is one of implementation. Governance reforms in CPSEs are politically contentious and challenging to implement, because political masters do not want to cede control of these national assets and other entrenched groups may oppose or find other ways to resist reforms. There are three broad areas where further reform needs to be undertaken, viz. strengthening the state's ownership role, professionalising CPSE boards, and protecting minority shareholders' rights.

The main challenge lies in making a complex and control-oriented ownership framework more effective in striking the right balance between CPSE autonomy and accountability. While boards have come a long way in becoming more professional over the years, there is still substantial room for improvement, particularly in the area of vesting boards with greater decision-making authority while

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ensuring responsible and accountable behaviour so that CPSEs can avoid political interference in their day-to-day functioning.

Recent measures taken by the government in the light of the increasing fiscal deficit and slowdown in disinvestment will exacerbate these specific challenges, and in general bode ill for the PSE corporate governance regime in the country. In the Union Budget for 2011–12, the finance minister had set a public sector disinvestment[4] target of US$8 billion. Disinvestment fell short of the target by more than 50 per cent. According to the then finance minister, "The uncertain global economic climate, mainly due to the fallout of the eurozone crisis, has adversely affected financial markets. This has been responsible for slowing down public sector disinvestment." To make up for the shortfall in the disinvestment target, the Union Cabinet in March 2012 approved buyback of the GoI's equity by cash-rich PSEs (with low to moderate capital expenditure requirements for 2012–13), listing of profitable subsidiaries of PSEs, and cross-holding among PSEs. SEBI on its part has relaxed the norms for buyback of shares and dilution of equity. The Cabinet Committee on Economic Affairs (CCEA) has also permitted financial institutions to buy the government's equity stake in PSEs.

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The next section looks at how government's interference and measures have negative implications for the PSE oversight structure, rights of minority shareholders, ownership structure of PSEs, board functioning, and risk management.

1. Creating Further Complexity in Oversight Structure

The Department of Disinvestment has identified, for the purpose of share buyback, some 20 cash-rich PSEs (mostly Maharatna, Navratna and Miniratna companies) that account for a cash reserve totalling nearly Rs. 200 billion. Share buyback would adversely affect

[4] Corporate governance reforms have been part and parcel of the broader CPSE reform programme. Substantial progress has been made in removing barriers to competition, reducing government financial support, and listing of CPSEs on the capital markets or disinvestment. Disinvestment of GoI equity in CPSEs began in 1991–92. Initially the disinvestment was primarily through sale of minority shares in small lots. Later, the emphasis of disinvestment changed in favour of strategic sale. At present, the emphasis is to list large and profitable CPSEs on domestic stock exchanges and to selectively sell small portions of equity in listed, profitable CPSEs (other than Navratna). It has been decided not to privatise profit-making CPSEs; make all efforts to modernise and restructure sick public sector companies and revive sick industry; sell or close the chronically loss-making companies after all the workers have got their legitimate dues and compensation; and induct private industry to turn around companies that have potential for revival. A "National Investment Fund" was set up in 2005 into which the proceeds from disinvestment of government equity in CPSEs are channelled. The fund is maintained outside the Consolidated Fund of India and is managed by selected public sector mutual funds for providing sustainable returns without depleting the corpus. As much as 75 per cent of the annual income of the fund is used to finance selected social sector schemes to promote education, health and employment. The residual 25 per cent is used to meet the capital investment requirements of profitable and revivable CPSEs (World Bank, 2010).

their capital expenditure and as such not all PSEs are enthusiastic about it. The Prime Minister's Office (PMO) has now instituted a four-tier scrutiny to evaluate investments of cash-rich PSEs that do not want to participate in the share buyback. Their investment plans will be built into the MoU and the PSEs will be appraised accordingly. The sector ministry will also be held accountable for the investment plan. The National Manufacturing Competitiveness Council will hold a quarterly review and report to the PMO for appropriate follow-up. This clearly shows that the autonomy granted to PSEs is being curtailed, and their CEOs are being forced to consult their administrative ministries on matters that would generally not require such consultation. This defeats the purpose of the 1997 DPE guidelines that gave large and important companies special status and greater functional autonomy in decisions about investments, capital expenditures, joint ventures, mergers and acquisitions, and raising of debt from the capital markets, besides delegating substantial decision-making powers to the boards of the leading CPSEs.

Institutional arrangements for exercising the state's ownership rights[5] are already considered complex compared with international practice. Two additional layers of oversight have now been added through the institutions of the PMO and the National Manufacturing Competitiveness Council. With this complex and control-oriented ownership framework, both CPSE autonomy and accountability will suffer.

2. Tunnelling of Funds

Again, to meet the disinvestment target and collect the surplus cash of PSEs, the Ministry of Finance (MoF) has allowed cross-holding among CPSEs. This proposal would allow the government to raise cash by selling a stake held by it in one public sector company to another and *vice versa*. GoI's plan is to restrict the cross-holding of one PSE in another to 10 per cent. Cross-holding among PSEs would mean reduced investible resources. Allowing CPSEs to acquire equity in other PSEs is akin to "tunnelling" of funds from one company to another within a business group. Although cross-holdings will reduce the government's direct holdings in the respective PSEs, the controlling shareholder can use indirect ownership to exert control over firms. The cross-holdings plan was first introduced by GoI in 1998 for profitable oil PSEs. It was, however, undone five years later, citing conflict of interest among these PSEs, which had their own growth plans. Cross-holding among PSEs will lead to a business group characterised by a complex ownership

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[5] GoI shareholding in CPSEs is held by the President of India, *ex officio*. The President's powers as a shareholder are delegated to 38 administrative ministries, each with its own portfolio of CPSEs. The DPE serves as the nodal agency. In addition, a number of other governmental bodies have oversight (Cabinet, MoF, Parliament, CAG, CVC, judiciary), regulatory (SEBI, MCA and sector regulators), and recommendatory roles (PESB, BRPSE and SCOPE).

structure, which generally takes the form of a pyramid (La Porta *et al*, 1999). In a pyramidal ownership, where a firm is controlled through a chain of companies, the controlling shareholder often has the possibility to transfer funds from one firm to another. This practice is called tunnelling and it may be highly profitable to the controlling shareholder (GoI). The pyramidal ownership structure gives incentives for self-dealing transactions by the controlling shareholder. The controlling shareholder may find it profitable to tunnel resources from a firm in the pyramidal chain to itself or to another firm, at the expense of minority shareholders of the former firm. Thus there may be a conflict of interest between the controlling shareholder and minority shareholders.

Section 297 of the Companies Act requires board approval for entering into any arrangement with related parties. However this section covers only certain transactions. There is also a requirement to take central government approval if the company in question has more than Rs. 10 million in paid-up capital. But section 297 (2) provides exemption on getting approvals. Clause 49 of the Listing Agreement necessitates that the audit committee review all related party transactions and disclosure by companies on materially significant related party transactions that may have potential conflict of interest. The related party disclosures to meet the requirements of AS 18 are not as detailed as those of US GAAP.

3. Rights of Minority Shareholders

Listed CPSEs have large numbers of minority shareholders, some more than 100,000 each. These shareholders are protected by the relevant provisions in the CA and SEBI regulation, including disclosure requirements, the right to receive notice of and participate in the general shareholders meeting, and transfer their shares and receive dividends. Like other shareholders, they can appeal to the MCA or SEBI if their rights are violated. Despite these legal provisions for minority shareholders to play a role in the governance of an SOE, the special status of listed CPSEs limits that role. DPE guidelines and 51 per cent state ownership ensure that key decisions, including board selection and major transactions, are made by GoI or the directors. Special provisions in the CA for government companies further limit the say of non-state shareholders and reinforce the role of the GoI (World Bank, 2010).

Although the government is no longer the sole shareholder in these companies, it behaves as though it is one, with scant regard for minority shareholders' interest. Share buyback, and cross-holding among PSEs are detrimental to the interests of minority shareholders, as the capital these companies could use to invest for growth and higher shareholder value will instead be used for the benefit of the controlling shareholder.

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The proposed legal action of The Children's Investment Fund

(TCI) against GoI for alleged breach of international treaties over its investment in Coal India Limited (CIL) is a case in point in the context of abuse of minority shareholder interests. TCI is the largest foreign shareholder in CIL; the state owns 90 per cent of the company. The government was accused by the auditor-general of forgoing US$210 billion in potential revenues by selling coal assets too cheaply to some of the country's leading industrialists. CIL had informed its customers in 2011 that there would be a price increase beginning January 1, 2012. However, users complained to the government. Other public sector units, which are major consumers of coal, also lobbied their own ministries. According to TCI, the government then wrote to CIL asking the company to reconsider the price increase. Used to obeying government orders from its pre-public issue days, the increase was promptly withdrawn. According to TCI, the decision does not make commercial sense for the company and that it is damaging the interests of minority shareholders. CIL's prices for some grades are as much as 70 per cent cheaper than imported coal, and the market should well be able to absorb an increase (Knowledge@Wharton Today, 2012). TCI was forced to file a legal case against CIL and its directors in October 2012.[6]

4. Board Functioning

In order to contain its fiscal deficit, the government has periodically directed state owned financial institutions to invest in PSE shares. To facilitate this, the government appoints CEOs of CPSEs as independent directors on the boards of other CPSEs, and appoints government nominees in board committees. The government's argument is that the influence through board positions would be beneficial for these companies, many of which do business with each other. The World Bank study[7] of 2010 on CPSEs suggests that while PSE boards have come a long way in becoming more professional over the years, there is still substantial room for improvement. GoI has taken a number of steps to professionalise and empower CPSE boards. Starting in 1992 and progressing over the years, the emphasis has been on improving the composition of boards, inducting independent directors to bring greater balance and expertise and reduce the scope

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[6] Although shareholder activism is rare in India, TCI has managed to set a precedent when independent directors refused to approve the price pooling policy of the PMO. This will prevent CIL from subsidising imports to users who have set up plants since 2009, thereby protecting the interests of CIL and its minority shareholders.

[7] "Particularly in the case of Navratnas, Miniratnas, and other profit-making companies, boards could be made more effective by bringing in independent directors from the private sector, empowering boards with greater decision-making authority while ensuring fair and responsible behavior through integrity and accountability mechanisms, strengthening audit committees, introducing performance-based board evaluation and remuneration practices, and making board development and leadership programs mandatory (World Bank, 2010)."

for political interference, and delegating decision-making powers to the boards of Navratna, Miniratna, and profitable companies. Since 2002–03, listed CPSEs have had to comply with corporate governance requirements introduced by SEBI through Clause 49 of the Listing Agreement. More recently, the 2007 CG guidelines endorsed SEBI's requirement on independence of boards and has stipulated that, for listed CPSEs, at least half the board needs to be independent, and for unlisted CPSEs, at least a third needs to be independent. But encouraging PSEs to aspire for board positions in other PSEs will lead to boards becoming unwieldy and to situations in which the various constituents work at cross purposes, each pursuing a different agenda. In predetermining the board's priorities, there will be a risk that ministerial diktats will take precedence over strategic and commercial considerations.

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5. Risk Management

DPE guidelines place a special focus on enterprise risk management. According to the guidelines, risk management is necessary to help avoid damage to the entity's reputation and associated consequences. Given its significance, its oversight should be one of the main responsibilities of the board/management. The board should align risk management with the corporate and operational objectives and ensure that risk management is undertaken as part of normal business practice and not as a separate task at set times.

Direct domestic investment by the top listed CPSEs will either remain constant or will marginally drop in 2012–13 as against the 35 per cent increase reported in 2011–12. Experts attribute the flat investment to the prevailing high rates of interest in the economy. Therefore, CPSEs have raised funds amounting to Rs. 780 billion through bonds and external commercial borrowings (ECBs) in 2011–12, an increase from Rs. 534 billion in 2010–11. The government has also allowed companies to raise ECBs to finance their rupee denominated loans for their ongoing projects. While the stock of ECBs is low (6 per cent of GDP), the level of amortisation has increased sharply, pushing up the economy's annual gross financing requirements. The government has successively made ECBs easier and cheaper to access, which runs the risk of building vulnerabilities in the medium term.

Around 60 per cent of foreign loans are unhedged. One of the lessons learnt from the financial crisis has been that underscored by the widespread failure of risk management. Unhedged foreign currency loans suggest that the lessons of the financial crisis still need to be learnt in India. There is a considerable systemic risk to the economy as there is a slowdown in investment, especially in the crucial infrastructure sectors, and an increase in unhedged foreign loans. In addition, a glut of foreign currency convertible bonds, issued when the rupee was much higher, falls due in the coming quarters. The bonds are too expensive at current levels to be converted into stock and the sharp depreciation of the rupee will leave issuers with a heavy redemption bill. All this means a higher debt service burden and low profitability for the companies that borrowed from overseas markets. In December 2011, a new accounting rule allowed companies with loans in foreign currency to move their mark-to-market (MTM) losses (in the light of the rupee depreciation) from their Profit and Loss (P&L) statement to their balance sheet.[8] For companies that chose this option, their foreign exchange losses could be capitalised or deferred. This was done to improve the reported profits and the earnings per share for the quarter as well as the year-end. Industry experts believed that this helped companies artificially boost the reported earnings numbers for the financial year. Financial statements prepared under the revised norms therefore did not reflect the true state of the financial health of the company (Dhanorkar, 2012).

VI. Conclusion

CPSEs continue to play an important role in the Indian economy. CPSE performance has improved over the years as a result of various reform measures and general improvements in the economy. Notwithstanding these improvements in the performance of CPSEs, improved governance and other measures have the potential to help raise the levels of performance even higher in the case of Maharatnas, Navratnas and Miniratnas. Improving CPSE governance would make the state a more effective owner of CPSEs, achieve higher levels of performance, improve their competitiveness, increase the value of important national assets, and achieve higher levels of transparency and accountability.

Despite an SOE governance reform programme that has been running for many years, there are significant governance challenges remaining. There are certain legal and financial privileges that favour CPSEs, distorting competition in the market. A complex ownership framework allows political interference in board appointments and commercial decision-making, affecting CPSE performance negatively in the long run. Further political interference will lead to the undoing of

A complex ownership framework allows political interference in board appointments and commercial decision-making, affecting CPSE performance negatively in the long run.

[8] Under the new rule (Rule 46A), a company can either transfer the loss to the balance sheet or adjust it against the income statement. In the former, if the long-term foreign currency borrowing is for acquiring a fixed asset, the company will be allowed to "capitalise" the exchange difference. The loss due to currency fluctuation can be directly added to the cost of the underlying fixed asset as given in the balance sheet. This means that the company will not need to adjust its profits for the exchange difference, which will help it avoid showing a loss in the income statement. If the loan is not for acquiring a fixed asset, the company can create a special account where the gains and losses can be adjusted. Alternatively, companies can write off the entire loss through the income account in the same quarter or defer the recognition of the exchange difference and amortise it over the borrowing period. This means that a firm can gradually adjust any difference from its profits over a period of a few years instead of doing it at one point. Companies that opt for either accounting method will be unable to reverse their decision later if the choice they have made is not working in their favour (*The Economic Times*, January 16, 2012).

the number of reforms implemented over the years to improve the efficiency and performance of CPSEs. Furthermore, because of the existing macroeconomic situation, GoI is not only using CPSEs to fill the revenue gap, but also changing the governance structure of CPSEs to the detriment of their long-term performance. This risks negating the reforms so far undertaken and the attendant improvement witnessed in CPSE performance over the years.

Despite these backward movements, there are signs of reforms in line with the OECD SOE Guidelines for the future; for example, the Parliamentary Estimates Committee in its latest report (52nd report) has highlighted its concern over the absence of a government organisation that would provide policy and overall guidance to the CPSEs. The report has drawn attention to the need for setting up a centralised coordinating unit that could make continuous appraisal of the performance of public enterprises.

List of Abbreviations

BRPSE: Board for Reconstruction of Public Sector Enterprises
CA: The Companies Act, 1956
CAG: Comptroller and Auditor General of India
CAGR: Compounded Annual Growth Rate
CAPEX: Capital Expenditure
CCEA: Cabinet Committee on Economic Affairs
CEO: Chief Executive Officer
CG: Corporate Governance
CMD: Chairperson and Managing Director
CPSEs: Central Public Sector Enterprises
CVC: Central Vigilance Commission
DPE: Department of Public Enterprises
ECBs: External Commercial Borrowings
GDP: Gross Domestic Product
GoI: Government of India
IAS: Indian Accounting Standards
ICAI: The Institute of Chartered Accountants of India
IFRS: International Financial Reporting Standards
MCA: Ministry of Corporate Affairs, Government of India
MoF: Ministry of Finance, Government of India
MoU: Memorandum of Understanding
MTM: Mark to Market
OECD: Organisation for Economic Co-operation and Development
P&L: Profit and Loss
PIB: Public Investment Board
PMO: Prime Minister's Office
PSEB: Public Sector Enterprises Board
PSEs: Public Sector Enterprises
SEBI: Securities and Exchange Board of India
SOEs: State-Owned Enterprises
RTI: Right to Information Act, 2005

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