

# CORPORATE GOVERNANCE IN THE PUBLIC SECTOR: DIMENSIONS; GUIDELINES AND PRACTICE IN INDIA AND NEW ZEALAND

*Frank Scrimgeour\**, *Geeta Duppati\*\**

## Abstract

Corporate governance is obviously a matter of global concern and has gained tremendous importance in recent years in the context of globalisation of economies and financial markets. The financial crisis of 2008 and the 2012 European crisis involving Greece, Italy and Spain revealed corporate governance failures in financial institutions and corporations, leading to systemic consequences (Classens and Yurtoglu, 2013). Earlier, two major scandals: Enron and WorldCom in the USA resulted in the enactment of Sarbanes Oxley Act, 2002 as a measure to ensure and restore investors' confidence in business in particular and the interest of society at large. This led to corporate governance reforms worldwide impacting corporate board composition, conduct, and responsibility at the legal and regulatory levels.

**Keywords:** Corporate Governance, New Zealand, India, Public Sector

\* *Department of Economics, Waikato Management School, University of Waikato, Hamilton, New Zealand*

\*\* *Senior Lecturer, Department of Finance, Waikato Management School, University of Waikato, Hamilton, New Zealand*

## 1. Introduction

The global crisis in 2008 has drawn further attention to SOEs as governments considered their impact on budgets and financial sector stability. Even where SOE performance is good or equivalent to the private sector, governments seek better performance by further adjusting governance practices. State-owned enterprises are an essential part of socio-economic activity in emerging countries. Most state-owned enterprises (SOEs) were established to fulfill the social objectives of the state rather than to maximize profits. The presence of SOEs in sectors like energy, utilities and infrastructure show, the governance of these SOEs is critical to ensure a positive contribution to a country's overall economic efficiency and competitiveness. This is because large sections of the population and business community depend on their services and product deliverables.

In a number of countries like India, China and Malaysia, State-Owned Enterprises (SOEs) represents a considerable portion of GDP and employment. SOEs represent a major part of the economy in China by contributing 30% of GDP and in Vietnam by contributing 38% of GDP, while in India and Thailand they contribute around 25% of the GDP, in Malaysia and Singapore it is 15% of the GDP (OECD, 2010). Due to the enormous scale and size of SOEs in these economies specific attention to their corporate governance is appropriate.

Corporate governance is most often linked to a very specific micro-economic or managerial problem setting, but neglects the institutional, legal, and cultural environment in which organizations and decisions are embedded. The majority of the popular studies documented in the literature surrounding corporate governance are from the USA and based on the Anglo-saxon model and an agency perspective (Jensen and Meckling, 1976; Jensen, 1986; Fama and Jensen, 1983a, 1983b; Demsetz & Lehn, 1985; Holderness & Sheehan, 1988).

According to Shivdasani and Zenner (2004), the empirical evidence relating to corporate governance studies from US may have little relevance to outside world. For instance, the board's objective under Anglo-Saxon model which underlies U.S. corporate law, is shareholder wealth maximization. This objective may differ in other jurisdictions. This indicates important governance differences exist across the world, driven by local regulations, laws, and cultural forces, and must be examined on a case-by-case and country-by-country basis.

Local corporate governance systems partially account for governance feature in Japan (Aoki, Jackson, & Miyajima, 2007), East Asia (Feenstra & Hamilton, 2006; Hamilton, Feenstra, Choe, Kim, & Lim, 2000), a wide range of European countries (Lubatkin, Lane, Collin, & Very, 2005; O'Sullivan, 2000a; Pedersen & Thomsen, 1997; Prowse, 1995; Rhodes & van Apeldoorn, 1998; Weimer & Pape, 1999; Whittington & Mayer, 2000),

and the new emerging markets (Chung & Luo, 2008; Khanna & Palepu, 2000; Singh & Gaur, 2009).

Majority of the studies in corporate governance are centred around the principal-agent relationships and principal-principal agency relationships. But the consideration given to the institutional and contextual framework is minimal (Globerman, Peng, and Shapiro, 2011; Jackson & Deeg, 2008; Aguilera, Filatotchev, Gospel, & Jackson, 2008; Fligstein, 2001; Roy, 1997; Scott, 2003 & Dobbin, 1994). Likewise, the economic, social and political conditions vary by country, and a more subtle understanding of how these factors are continuously shaping the business environment is critical to spotting new opportunities and managing unexpected risks. Therefore, the present study takes a holistic approach and sees if the corporate governance framework differs in different settings.

## 2. Theoretical Framework and Extant Literature

Theoretically, this paper is built up on the wider perspective of the principal-agent relationships involving four layers of these relationships in SOEs. The idea is straight forward. First layer involves general public (who are deemed to be the real owners of the SOEs) and government; Second layer involves government and ministers, third layer involves ministers and boards and fourth layer involves Boards and the management. Therefore, the governments and ministers who function as principals to the managers in SOEs are themselves part of a more evolved chain of delegation which runs from voters and their representatives in parliament to the cabinet and individual ministers and further to the administrative apparatus of the state and then the boards and management (Huber 2000; Lupia 2003; Müller 2000; Strøm 2000; Mishra & Duppatti, 2007).

**Figure 1.** Theoretical Model: Four Layers of Principal Agent Relationships



In spite of the corporate governance reforms the underperformance of state owned enterprises continued to be a prominent concern in the extant literature. A state-owned firm faces organizational costs associated with two types of internal conflict of interest, namely, political costs associated with government (owner) incentive to intervene in the firm, and agency costs associated with a manager's incentive to expropriate wealth from the firm (Shleifer and Vishny, (1994); Qian, (1996) and Fan, (2012)). Whether these costs can be contained is the key to the success of SOE reform. Jedenastik (2013), argues that managers in public corporations are part of the chain of delegation that structures much of the political process and his results support the proposition that partisan affiliation drives managerial survival. The study undertaken by Reddy, Locke and Scrimgeour (2011) investigated the nature of corporate governance practices in public sector corporate entities in New Zealand and their effects on financial performance.

Using agency theory as the dominant theoretical paradigm, the extant literature has mainly focused on the efficacy of various governance mechanisms that protect the shareholders from self-serving managers (Rajagopalan & Zhang, 2008). Much of the research is situated in the context of developed economies,

where the external governance environment and institutions to support the internal firm governance are stable and well developed (Judge, Douglas, & Kutan, 2008).

While a focus on within firm governance mechanisms has advanced our understanding of the links between governance standards and firm performance, there is an increasing realization that the efficacy of within firm governance may be dependent on the quality of external governance and institutions (Judge et al., 2008). This issue is particularly important for emerging economies, which often lack the institutions needed to support efficient within firm governance (Peng, 2003). It is well documented that many emerging economies, such as India and China, do not have well developed external control mechanisms, such as a market for corporate control, merger, and acquisition laws, and efficient law enforcement (Khanna & Palepu, 2000a; Peng, 2003).

This not only makes it more difficult to govern the organizations, but also makes standard CG practices less legitimate (Judge et al., 2008). It is evident from the literature presented above that there is gap in the literature from cross country comparative perspective involving SOEs. Majority of the studies involving agency perspective are undertaken from the context of listed companies.

This paper extends the literature beyond the firm level agency perspective. It considers the OECD Guidelines on corporate governance of SOEs as a basic framework, and explores how the challenges of corporate governance have been addressed in state-owned corporations of India and New Zealand. The study seeks to accurately describe the different approaches taken and report on their perceived effectiveness.

The study addresses the following questions:

- What are the corporate governance practices in state-owned enterprises (SOEs) in India and New Zealand? and
- To what extent may practices be borrowed or adapted across international boundaries?

The study highlights gains that have been achieved, difficulties that remain, priority actions for improving SOE governance, and the identification of governance issues that require future research.

### 3. Corporate Governance and OECD Guidelines

Challenges to the SOEs persist in spite of the corporate governance reforms of state owned enterprises in many countries. This is because the principal-agent relationships exist in multi-layers in SOEs. According to Jedenastik (2013) the complex nature of corporate governance in SOEs is because of four types of principal-agent relationships involved in SOEs ranging from government, ministries, boards, senior management and other major stakeholders. The complications are intensified with the interference of government. For instance, Muller (2002) shows how political parties intervene in the chain of delegation in parliamentary democracies. The study of Meyer & Hinrik (2006) on the ministerial bureaucracy reveals that the passing of public administration reforms has not provided an effective constraint against politicization of the ministerial bureaucracy which has increased over time in terms of extent, intensity and scope in enhancing their political control over the formulation and implementation of public policies. Mwaura.K (2007),<sup>8</sup> argues that the initiatives undertaken to make parastatals (SOEs) more efficient are inadequate and will not realize the intended objectives unless the chief executives of parastatals are hired on a competitive basis, given more autonomy and the government is committed not only to designing performance contracts that set realistic standards, but also enforcing them strictly. According to Osamu Koike (2013), the goal of achieving efficient and workable public administration is attained when political leaders builds the rational legal bureaucracy through reduced patronage influence, creates networking governance, allows engagement with civil society, and fosters high

employee motivation for achieving efficient and accountable government.

The concerns relating to corporate governance and performance are manifested in various forms, like: under-performance, corporate collapse, corporate corruption and so on. For instance, the top three Indian SOEs<sup>9</sup>, namely: Bharat Sanchar Nigam Ltd, Air India Ltd and Mahanagar Telephone Nigam Ltd alone incurred a loss equal to 74.35% of the total loss of all SOEs in 2011-2012. These companies were incurring losses consecutively, since 2009 onwards.

The Aviation sector in India is a case in point. It is cash strapped sector with issues ranging from increasing debt burden to cascading effect of taxes<sup>10</sup>, which are identified as key cost drivers and the aviation turbine fuel (ATF) price accounting for 40 % of the airlines' operating cost (Hindustan Times, 2012). The planning commission proposed a projected total outlay for the sector at over Rs. 547.43b for the entire plan period of 2012-17, including Rs. 329.6367b for Air India and Rs. 175b for the Airports Authority of India (Hindustan Times, 2012). Half of the "huge debt burden" of \$20b in 2011-12 was aircraft-related and the rest for working capital loans and payments to airport operators and fuel companies. The risk taking behaviour of the SOEs becomes an issue in the market driven economy (Locke and Duppati, 2013).

Likewise, the collapse of Solid Energy, a state owned enterprise in New Zealand in 2012 indicates the challenges involved in the corporate governance of SOEs. Solid Energy is a case of corporate board's failure (Its borrowings soar from just \$15 million in 2007 to nearly \$400 million IN 2013<sup>11</sup> and impairment charge of \$149 million in 2012. Who is to blame? Is it the Government shareholder, the board of directors or Don Elder, CEO and his management team? The Prime Minister John Key was blaming Trevor Mallard and the previous Labour Government because they encouraged state-owned-enterprises to expand in 2007).

It is therefore, evident that the corporate governance is a major challenge in many economies. In the absence of the International benchmarking practices of corporate governance, the OECD guideline provides a concrete suggestion to resolve various corporate governance issues and dilemmas. To remain competitive and to conduct the business that delivers results, it is vital for SOEs to have good corporate governance system in practice. Since OECD guidelines are developed from the best practices of successful corporate experiences, it is suggested to

<sup>9</sup> Department of Public Enterprise survey report of 2011-2012.

<sup>10</sup> It refers to the point that the industry is faced with many taxes like those on fuel, aircraft leases, airport charges, air passenger tickets, air navigation service charges, maintenance costs, fuel throughput fees and other charges.

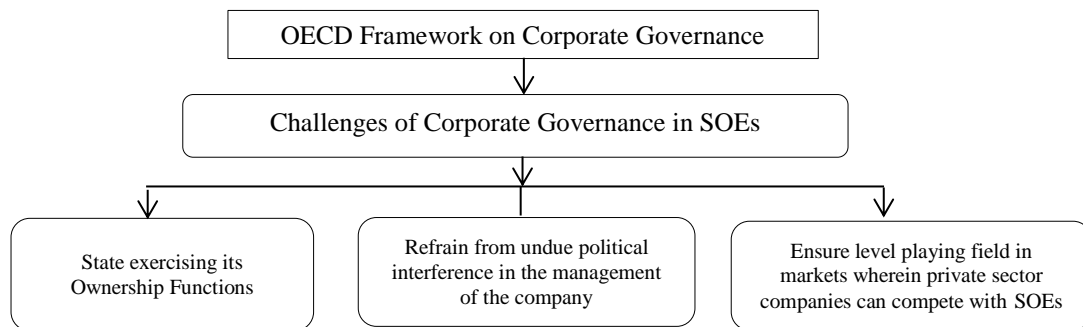
<sup>11</sup> Brian, Buck stops with the Solid Energy board, 5:30 AM Saturday Mar 2, 2013

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compare the New Zealand and Indian practices with OECD guidelines. The OECD guidelines are developed based on the challenges of corporate

governance in SOEs which are included in the OECD Framework presented below:

**Figure 2.** Challenges of Corporate Governance in SOEs



A consideration of the OECD framework presented above leads to the following questions:

- Is the ownership policy in place for the SOEs? If yes, what are the points emphasised?
- Are the companies owners managed or board managed?
- Is there a mechanism to ensure accountability and responsibility of Boards and Management?
- Is a comprehensive selection procedure in place for the Boards

For the ease of presentation, the questions raised above are discussed under the following headings from the context of New Zealand and India:

- Shareholding ministers: Rights, Powers, Delegation of Authority, Responsibility, Accountability, Monitoring and Reporting
- Boards: Rights, Powers, Responsibility, Accountability, Monitoring and Reporting
- Senior Management: Rights, Powers, Responsibility, Accountability, Monitoring and Reporting

### 3.1 Contextual Background of New Zealand and India

Majority of the studies in corporate governance are centred around the principal-agent relationships and principal-principal agency relationships. But the consideration given to the institutional and contextual framework is minimal (Globerman, Peng, and Shapiro, 2011; Jackson & Deeg, 2008; Aguilera, Filatotchev, Gospel, & Jackson, 2008; Fligstein, 2001; Roy, 1997; Scott, 2003 & Dobbin, 1994). According to Filatotchev, Jackson & Nakajima (2012), the performance outcomes of boards of directors, ownership concentration, and executive incentives may differ depending on the legal system and institutional characteristics in a specific country. Therefore, following Filatotchev, Jackson & Nakajima (2012) the present study takes a holistic approach and looks into the corporate governance framework through the four layered agency framework and sees

if the corporate governance practices differs in different settings.

**New Zealand:** The case of New Zealand differs from many countries across the globe in terms of categorising and controlling the entities owned by the 'State'/the 'Crown'. The state entities are categorised based on their objectives rather than operating them with varying degrees of commercial orientation. Accordingly the government owned entities can be broadly classified into two categories. They are: State-Owned Enterprises and Non State-Owned Enterprises.

State-Owned Enterprises were established as part of the broader State sector reforms in 1980s, as limited liability companies under the subject to the Companies Act. These acts address the ownership, governance and public accountability arrangements for SOEs. These SOEs operate with commercial objectives. At present there are eighteen SOEs<sup>12</sup>.

While the Non-State Owned Enterprises includes Statutory Crown Entities (SCEs) which are enacted through the Crown Entity Act and Crown-Managed Funds. The SCEs have multiple objectives and are established to deliver many of the public services of importance to New Zealanders. There are currently five SCEs<sup>13</sup>. They are wholly Crown-owned non-company entities with boards, and have been given greater operational freedom than government departments on the principle that services will be more efficiently produced if the entity has discretion within a framework.

**India:** Public sector enterprises have been the backbone of Indian Economy since the time of independence in 1947. They influence growth in the economy and consume significant resources. As against the nominal GDP growth of 15.0 per cent (at current market price) in 2011-12, the gross value addition by all the CPSEs (exclusive of under-recoveries) grew by 4.24 per cent during the year (if

<sup>12</sup> Crown Ownership Monitoring Unit 2012 Annual Portfolio Report

<sup>13</sup> Crown Ownership Monitoring Unit 2012 Annual Portfolio Report

however, ‘the under recoveries’ are added, then the gross value addition by all CPSEs during the year increased by 7.38 per cent) (PSE, 2010-11). Indian CPSEs are in core sectors like Mining, Oil and Natural Gas, Electrical Power Generation and Distribution, Telecommunication, Iron and Steel, Heavy Water Resources, as well as industries in other verticals like fertilizers and Petro-Chemicals.

Corporate governance reforms which were initiated in 1990 as a part of corporate reforms in India were modified and intensified in the year 2000 to ensure comparable performance between the state-owned enterprises and their private counterparts in the competitive world. Interpretation of the impact of governance reforms is complicated by other commercial and economic events during the period. In response to the pressures CPSEs were facing by empowering those perceived as having a comparative advantage in terms of strategic importance, turnover, net worth and performance, with higher levels of autonomy and financial powers at different stances of periods i.e., 1997 & 2009, Government of India (GOI) identified 89 SOEs out of the total 239 SOEs, to ensure financial autonomy based on their cognitive activities and performance and classified them into three categories: Maharatna, Navratna and Miniratna<sup>14</sup>. Government had nominated these as being of strategic importance and having the potential to emerge as global players (Locke & Geeta, 2013 & Rath, 2012).

#### 4. Corporate governance and Four layer of the proposed SOEs frame work: A perspective

Accountability, according to Boland and Schultze (1996) is the capacity and willingness to give explanations for conduct, stating how one has discharged one’s responsibility’. It is this ‘giving and demanding of reasons for conduct’ (Roberts and Scapens, 1985, p.447) which is at the heart of the accountability process. Central to the discussion on accountability has been a distinction between ‘managerial’ and ‘political/public’ forms of accountability (cf. Day and Klien, 1987; Gray and Jenkins, 1993; Sinclair, 1995; Ahrens, 1996). The latter is assumed to apply particularly to governments who are accountable to their electors for the *authority* granted to them whereas the former applies to managers being made accountable for the *responsibilities* delegated to them. Implicit in this distinction is a view about control. In the case of governments it is assumed that the direct control of the electorate is limited. On the other hand in the context of managerial forms of accountability there is an assumption that the person or being who delegates responsibility (often referred to as a ‘principal’) to another

(often called an ‘agent’) can and has power to exert pressure over the performance of the latter. One of the key arguments of this paper is that pressure on governments can change the level of specificity of the nature of the political/public accountability that is offered but cannot provide the electorate with direct control of the day to day activities of governments. This leads to deviation from the public interest while pushing the political agenda, thereby resulting in the agency conflicts.

Due to factors such as bureaucratic interference, conflicting objectives, and weak managerial incentives, state ownership is frequently regarded as a major cause of corporate inefficiency (Boardman and Vining, 1989; Megginson et al., 1994; and Shleifer, 1998). There are evidences showing the adverse efficiency as a consequence of state ownership. A high degree of state ownership is often found among transformed SOEs in transition economies like India and China. Many studies have found that state ownership does not produce superior firm performance, but it is often linked to low efficiency (Bai, Liu, Lu, Song, & Zhang, 2004; Ding, Zhang, & Zhang, 2007; Yiu, Bruton, & Lu, 2005). This outcome is attributed to state shareholders’ pursuit of macro-economic and social objectives in addition to firms’ profit-maximizing goal, weakening the board’s monitoring and strategy roles (Berkman, Cole, & Fu, 2002; Djankov, 1999).

Prior studies find that state-owned firms do not serve the public interest particularly well (Grossman & Krueger, 1993) and state-owned firms are typically extremely inefficient (Boycko et al., 1996 and Dewenter & Malatesta, 2001). The conclusion of these studies is that generally the SOEs disregard social objectives and their value and this combined with SOE inefficiency is inconsistent with the idea that state ownership adds value. According to Sheifer and Vishny (1996), public choice theory complements the property rights approach and contributes to understanding inefficiency in the public sector through a focus on the behaviour of politicians and bureaucrats. Unlike their counterparts in the private sector, managers in the public sector lack focus because they are expected to pursue a variety of objectives, not all of which are related to financial performance.

This multiplicity of objectives arise from public sector managers being answerable to different constituents, such as legislators, civil servants and ministers, each with their own objectives. Politicians, who are answerable to constituents such as labour, may push public sector managers to pursue objectives, such as increasing employment which in turn mitigates against profit maximisation. Both the property rights and public choice analyses suggest that the behaviour and performance of managers will differ between the public and private sectors because both the objective functions are different and the constraints are different. Neither is good performance

<sup>14</sup>Please refer to Appendix 1 for more details on these categorisation

incentivised in the public sector nor is bad performance penalised through takeover or bankruptcy (Shleifer & Vishny, 1996).

#### **4.1 First and Second Layer of the proposed SOE model and corporate governance practices**

Duppati & Mishra (2007) examined the role of state level public enterprises (SLPEs) in India, and found blurred relationships between the general public as principal owners of the state property and government leaders as controlling agent exists. For improvements to occur there is a need for accurate and timely information from state enterprises and an appropriate process to monitor on an on-going basis. Although a difficult exercise SOEs should strive to benchmark performance with appropriate peers, domestic or foreign (OECD, 2005).

Politicians and bureaucrats, who are vested with the job of monitoring on behalf of the larger public, according to Kornai (1980), are not as good at monitoring or designing incentive systems as shareholders in a private company.

##### **4.1.a Reviewing the role of government as Owner from the perspective of New Zealand and India**

To ensure a better accountability, the OECD guidelines (Guidelines II.A.) suggest developing an ownership policy, as a primary task for state as an owner. It should include the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy. In other words it should clearly explain how the state behaves as an owner. Clear and published ownership policies thus provide a framework for prioritizing SOEs' objectives and are instrumental in limiting the dual pitfalls of passive ownership or excess intervention in SOEs' management.

With regards to ownership policy, New Zealand does not have a specific ownership policy but instead, the Companies Act of 1986 and SOE act 1986 provides the institutional framework<sup>15</sup> in which it articulates the principal objectives to be followed by the every state enterprise for the successful conduct of the business.

According to the Company's Act of 1986 the SOEs should operate in the open market and are subject to the same market and regulatory conditions and should compete on a level playing field as the other businesses which are not crown-owned.

<sup>15</sup> An institutional framework is generally understood to mean the systems of formal laws, regulations, and procedures, and informal conventions, customs and norms that broaden, mould and restrain socio-economic activity and behaviour (Defining an Institutional Framework for the Labour Market, No. 24, February 2012, Trevor Donnellan, Kevin Hanrahan and Thia Hennessy)

Competitive neutrality between SOEs and the private sector is ensured. Besides being a good employer, they should exhibit a sense of social responsibility by having regard to the interests of the community in which they operates and by endeavouring to accommodate or encourage these whenever it is possible to do so. Compensation is provided to SOEs in the situations where they undertake non-commercial activities as required by the Crown.

##### **4.1.b Institutional and Legal Framework**

The Government's policy in relation to SOEs has the following goals: i) to be clearer with SOE boards about shareholding Ministers' expectations of the companies; ii) to provide shareholding Ministers with a greater understanding of, and therefore confidence in, the performance of SOEs, through enhanced benchmarking; iii) to develop appropriate capital structures which impose financial disciplines on SOEs while ensuring they have sufficient capital to make operational investment decisions without recourse to the Crown, and iv) to ensure that requests for capital are considered in line with the business needs of the SOE, while recognising the Crown's preference that major investments are considered relative to other demands for capital across the Crown by incorporating SOE requests for equity for significant investments into the normal budget process.

SOEs generally fall under the legal framework Companies Act 1993 (Companies Act), Crown Entities Act 2004 (CE Act), Public Finance Act 1989 (PFA), and State-Owned Enterprises Act 1986 (SOE Act) and other entity-specific legislation like the New Zealand Railways Corporation Act 1981 for KiwiRail Group, or establishment Acts for each Crown entity

##### **4.1.c Shareholding Ministers Powers, Responsibilities, Accountability and Challenges Shareholding Ministers' Powers**

Under the SOE Act, shareholding Ministers are responsible to the House of Representatives for the performance of the functions given to them. Each SOE has two shareholding Ministers – the responsible Minister and the Minister of Finance. The responsible Minister (normally the Minister for SOEs) generally takes the lead shareholder role, particularly in his/her capacity as the formal point of contact with boards. The role of the Minister of Finance as an SOE shareholder reflects the importance of the sector to the Crown's economic and financial objectives. From time to time, shareholding Ministers may delegate some of their responsibilities. Under the SOE Act, shareholding Ministers are accountable to the House of Representatives for the performance of the functions given to them under the Act or the constitutions of the SOEs. The key accountability

document is statement of corporate Intent (discussed below).

In practice, shareholding Ministers' responsibilities include: appointing and removing directors (including chairs and deputy chairs); commenting on the content of draft Statement of Corporate Intent (SCIs) and business plans, including aspects that may be inconsistent with statutory requirements; tabling final versions of SCIs in the House of Representatives; developing and communicating the Government's ownership policies; monitoring board performance and taking necessary remedial steps should boards fail to meet the targets in their SCIs and business plans; consulting with boards as issues arise; tabling the SOEs' annual and half-yearly reports in the House of Representatives; taking decisions as shareholder (eg, approving a major transaction under the Companies Act, or other transactions if such approval is required under a company's SCI), and deciding on resolutions at annual meetings (or special meetings) or agreeing to pass written resolutions in lieu of such meetings.

#### 4.1.d Challenges of Monitoring

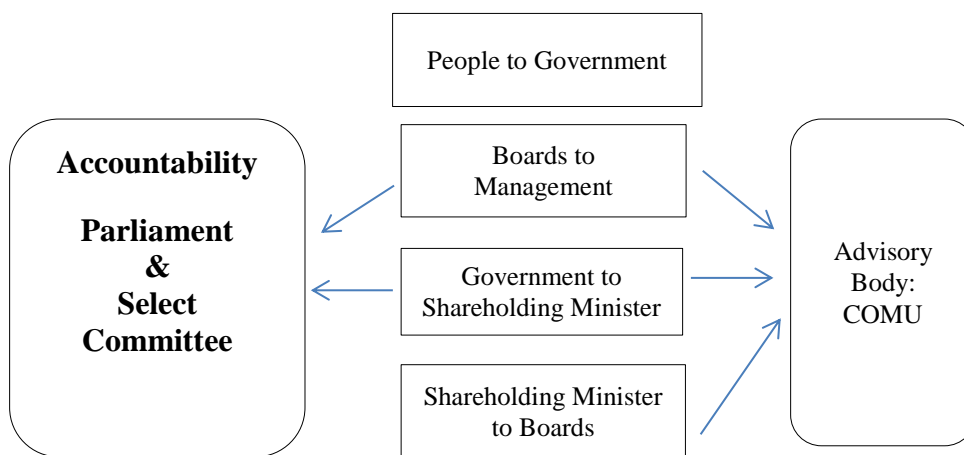
It is the responsibility of the government to manage its investments in the best interests of New Zealanders. Shareholding Ministers' monitoring function is parallel to that undertaken by equity holders in the case of private sector companies.

However, shareholding Ministers face certain limitations, when compared to the private sector equity holders: a) Cannot divest themselves of ownership of the SOE without empowering legislation; b) cannot monitor company performance because they are not listed and as such do not have a share price; and Besides both shareholding Ministers and the SOEs are subject to additional public scrutiny via select committees and the Official Information Act 1982 (the OIA).

For these reasons, it is important that shareholding Ministers receive timely and relevant performance information from SOEs. The SOE Act, therefore, gives shareholding Ministers certain powers over and above those of ordinary shareholders; for example, the power to require information relating to the affairs of an SOE.

The role of being a shareholding Minister can place heavy demands on Ministers. These demands can be eased by giving the Ministers access to advisors with an understanding of the key issues at the strategic, public policy and individual SOE level, and who can support the Ministers, and assist in the board appointment process. Shareholding Ministers receive advice on SOEs' financial and non-financial performance from COMU. Final decisions on all SOE issues remain with shareholding Ministers or Cabinet.

Figure 3. SOE Framework OF Corporate Governance: New Zealand Model



In case of India, the Department of Public Enterprises brought out comprehensive guidelines on corporate governance for SOEs. The Administrative Ministries, who are referred as delegated owners, represent GOI in the AGM, participate in board selection, approve major decisions, monitor performance, and restructure sick or loss-making units. Currently, 38 ministries and departments administer the 244 operational CPSEs. They consult other ministries and departments on various matters and obtain cabinet approval as required. While the Ministry of Finance (MOF) reviews many CPSE

finance and investment decisions, as does the Public Investment Board (PIB) for investment plans over Rs.100 crores (US\$2.3 million).

#### 4.2 Third Layer of the proposed SOE model and corporate governance practices

According to Anthony Cheung (2005) many Asian countries retain the features of a strong bureaucracy. Consequently, it has been difficult for political leaders to blame bureaucracy for its "budget-maximisation"

behaviour. It makes the background of administrative reforms in Asia fundamentally different from those of western democracies. Most of the East and South-East Asian countries with the exception of Japan, Singapore and South Korea, continue to have a tradition of “authoritarian regime.” In the process of national development, political leaders have emphasised “Asian values” rather than the democratic norms which originated in Western societies.

For instance, from the context of Hong Kong, Cheung (2013), findings shows that the present political configuration of governance in Hong Kong had largely thrived on the pre-1997 colonial logic of administrative state and government by bureaucracy. Such a system has now become hard to sustain due to rising political distrust and cynicism caused partly by the democratic deficit and the absence of the politics of responsibility. Hong Kong was a pioneer of public sector reforms in the 1980s and 1990s, but such reforms grounded in the NPM (new public management) logic of management efficiency no longer suffice to cope with the growing crisis of governability. It is argued that rebuilding trust and governability should be put at the forefront of the governance reform agenda.

According to Osamu Koike (2013), after the 1997 Asian financial crisis, many Asian countries, including developed and developing, have introduced a variety of performance management systems into their bureaucracies. This has been encouraged by international agencies as part of their “good governance” agendas. Despite this, the goal of achieving efficient and workable public administration has still not been realized in many cases. Anti-corruption measures are not effective, and efficiency and service delivery in public organization has not significantly improved. However, political leaders must recognize that the building of rational legal bureaucracy in which patronage influence is reduced, creating networked governance, allowing engagement with civil society, and fostering high employee motivation, are the other prerequisites for achieving efficient and accountable government.

#### **4.3 Fourth Layer of the proposed SOE model and corporate governance practices**

A state-owned firm faces organizational costs associated with two types of internal conflict of interest, namely, political costs associated with government (owner) incentive to intervene in the firm, and agency costs associated with a manager’s incentive to expropriate wealth from the firm (Fan, 2012).

As Qian (1996) points out, a fundamental motivation for empowering SOE managers in the first place is to reduce government interference, and therefore to lower the firm’s political costs. Although Chinese-listed SOEs are restructured into joint stock

companies with outside shareholders post-IPO, the government remains the majority owner and retains control of the board (Fan et al. 2007) and the right to appoint key officers, such as the chairman and CEO (Qian 1996). Government officials who have control rights over listed SOEs often pursue their own private political objectives at the expense of outside shareholder’s interest in maximizing firm value. For instance, the government owner can compel the firm to build public infrastructure, pay more taxes, or provide excess employment in the locality to alleviate fiscal and employment problems.

In addition to reducing political costs, empowering SOE managers is likely to induce higher incentives and improve productivity. The owner of an SOE, a governmental agency, typically faces decision making constraints due to insufficient expertise and information, and thus allocates some decision rights to SOE managers. However, empowered managers can expropriate substantial gains from the SOE, resulting in severe agency costs. This is because, unlike a private firm, an SOE does not have a “true” owner looking after firm interests. All else equal, the optimal division of power between the government and the SOE manager should be the point at which marginal agency costs are equal to marginal political costs.

Another reason that managers in the public sector lack incentives to perform is that they do not fear bankruptcy; thanks to the ‘soft budget’ constraint, managers in the public sector can expect to be bailed out by public funds. In addition it suggested that SOEs are often chronically unprofitable, at least in part because they are often charged with objectives such as maximizing employment and developing backward regions (Boycko, Shleifer, & Vishny, 1996) and (Ben-Ner, Montias, & Neuberger, 1993).

#### **4.3.1 Accountability of Boards**

New Zealand: Crown Ownership Monitoring Unit (COMU) and Boards Autonomy

Under the legislative commercial framework arising from the SOE Act and the Companies Act, SOE boards are responsible and accountable for the individual company performance, are the primary monitor of performance and are the main mechanism that the Ministers have in holding the company to account. To support the boards’ accountability and monitoring roles, COMU’s approach is underpinned by the seven principles outlined below: Key engagements are with entity boards; Prioritise our monitoring efforts in relation to the performance issues and risks within each entity; Portfolio perspective to ensure that the Crown’s balance sheet is fit-for-purpose; Provide independent analysis, commentary and judgements to Ministers; Provide performance information to the public through COMU’s website; Monitor international corporate governance changes and adjust the procedures as



appropriate and Sharing the knowledge with other government agencies undertaking monitoring roles, both in New Zealand and internationally.

Boards, particularly chairs, are expected to work closely and cooperate with COMU; as a conduit of information and advice to shareholding Ministers. Boards may wish to invite officials to be present during parts of board meetings or annual business planning sessions to discuss issues or to clarify shareholder expectations. Such invitations are entirely at the discretion of each board. SOE boards are also accountable to select committees. Select committees are key parliamentary institutions with which public servants and those working in the wider State sector have contact. The committees undertake detailed work on a range of different matters on behalf of the House, and report their findings to it.

Under the Companies Act, the board of the company is responsible for managing, by or under its direction or supervision, the business and affairs of the company. The Companies Act requires boards, among other things, to: Comply with the directors' duties set out in the Companies Act, including the duty to act in the best interests of the company; Provide an annual report and annual financial statements to the shareholder; Comply with the solvency requirements set out in the Companies Act; Hold AGMs, except where the shareholder passes a written resolution in lieu of such meetings, and Present special resolutions to the shareholder when necessary (eg, resolutions for the approval of "major transactions" as defined in section 129 of the Companies Act).

#### **4.3.2 Role and Responsibilities of the Boards**

The role of the board of a Crown company differs in some respects from the board of a privately owned company. For example, all decisions relating to the operation of a Crown company must be made by, or pursuant to, the authority of the board in accordance with its SCI or Statement of Intent (SOI). Further, under the constitution of each Crown company, the Ministers, rather than the board, appoint the chair and deputy chair and set directors' fees.

A Crown company board's responsibilities include, but are not limited to, the following: Appointing a CEO and managing and monitoring the CEO's performance; Setting the CEO's remuneration and incentives, approving senior management remuneration and remuneration policy generally, and specifically determining the relationship between remuneration incentives and risk taking; Providing leadership and vision to the company in a way that will enhance shareholder value; Developing and reviewing the company strategy; Ensuring that the company has appropriate processes to identify, assess, monitor and manage risk and monitoring the performance of senior management; Reviewing and

approving the company's capital investments and distributions; and Ensuring compliance with statutory requirements providing leadership in its relationships with key stakeholders including, where relevant, industry groups, Māori and staff

#### **4.3.3 COMU as an advisory body to the Shareholding ministries**

COMU has four teams that together provide shareholding Ministers with comprehensive advice. These teams are: Sector Monitoring teams: The advisors within these teams monitor a range of entities. Each entity has a senior relationship manager as their key point of contact. The relationship manager should be sent all routine reporting (eg, quarterly, half-yearly and annual reports), other process-related documents and other relevant updates. The Sector Monitoring teams focus on:

- Developing and reviewing ownership objectives for individual SOEs and the SOEs as a whole;
- Advising on strategic issues, ownership policy issues, investment and diversification opportunities, restructuring issues and capital structure;
- Analysing business cases where they are required to consult with, or seek the approval of, shareholding Ministers
- Commercial opportunities and risks the environment in which the entities operate, and
- Protecting and enhancing shareholder value.

Financial Analysis unit: This unit provides in-depth financial analysis on individual entity performance and on the overall portfolio. The unit also undertakes specific exercises for shareholding Ministers such as independent valuations, benchmarking performance (where possible) and authoring an annual portfolio performance report.

Appointments and Governance team: This team supports and provides advice to the Ministers on appointments of boards and governance issues oversees candidate management issues and provides targeted professional development opportunities.

Sector Performance and Balance Sheet team: The Treasury manages the Crown's finances and is the Government's principal advisor on economic, fiscal and financial issues. This team works to ensure that the Crown's balance sheet is well understood, has a well-articulated strategy for change and is well managed, and contributes to better balance sheet management across the Crown's portfolio. This work encompasses analysis and advice on issues across the Crown's entire balance sheet, not just the entities monitored by COMU.

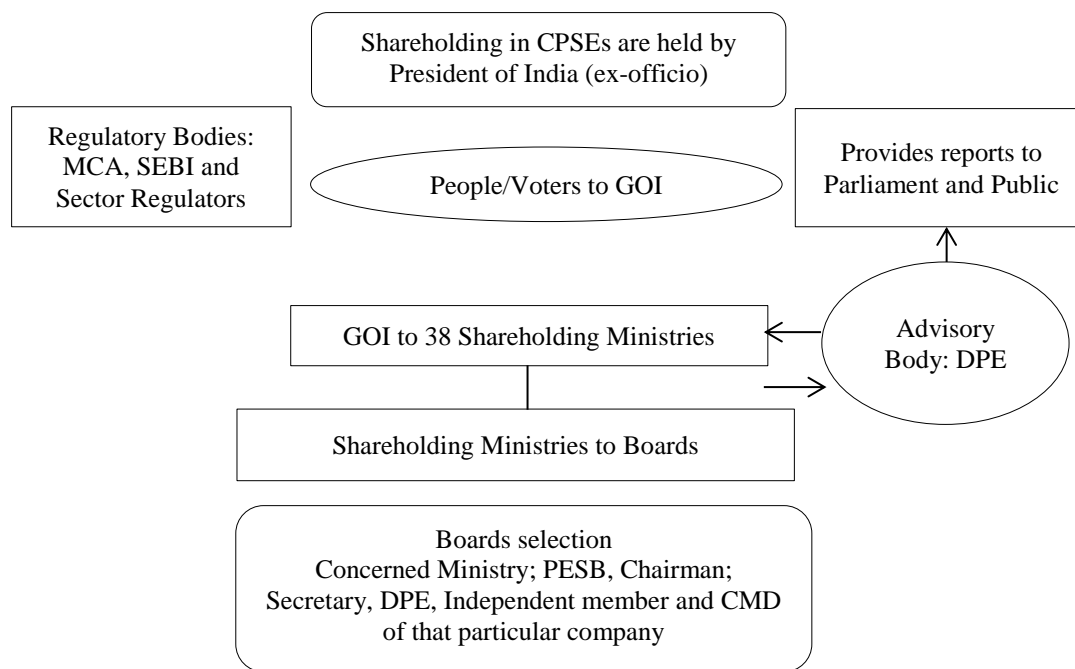
#### **4.3.4 Accountability of Boards**

Indian SOEs are accountable to a number of different bodies, including:

Parliament: As the main oversight body, a number of parliamentary committees routinely review CPSE performance and related issues. Comptroller and Auditor General (CAG): CPSEs with more than 50 per cent of ownership are subject to CAG oversight. An independent body established by the Constitution of India, CAG: (i) appoints the statutory auditor and oversees and supplements their work; (ii) conducts regular transaction audits of CPSEs; (iii) conducts performance audits of CPSEs that focus on particular topics and sectors; and (iv) reports the findings to parliament. Central Vigilance Commission (CVC): CVC has a mandate to deter corruption and malpractice in CPSEs through observance of procurement matters and clearance for all board

positions. Judiciary: CPSEs are subject to judicial review by the Supreme Court of India and the High Courts. Regulatory bodies: These bodies oversee CPSEs in much the same way as they oversee private sector companies. They include: (i) SEBI, which enforces securities rules for listed CPSEs; (ii) Ministry of Company Affairs (MCA), which oversees compliance with the Companies Act; and (iii) sector regulators, like the Telecom Regulatory Authority, which regulate pricing and other sector specific issues for relevant CPSEs. Recommendatory bodies: These include: (i) the Public Enterprises Selection Board (PESB), which manages the process for selecting board members, including tenders and advertising.

Figure 4. SOE Framework OF Corporate Governance: Indian Model



#### 4.3.5 Reporting – Corporate Business Plan

##### New Zealand

The SOE Act provides a comprehensive outline of SOE requirements with regard to its key accountability document the SCI and reporting performance to shareholding Ministers and the wider public, through the House of Representatives. The SOEs are expected to report the Business plan and statement of Corporate Intent ahead of the start of the financial year. Most companies have a 30 June financial year. Shareholding Ministers aim to send an expectations letter to each SOE board between October and January of each financial year detailing the information requirements, the timing and any specific issues the company is expected to address during the business planning round.

In response to the expectations letter, the board may send a strategic issues letter to the shareholding Ministers by the end of January, outlining major issues the company expects to address during the business planning round. Subject to commercial sensitivities, the expectations letters are publicly released on the COMU website. Each SOE board provides shareholding Ministers with a draft SCI, supported by the company’s business plan. The business plan enables shareholding Ministers and COMU’s officials to assess the draft SCI.

The SOE Act requires the board of each SOE to deliver its draft SCI to shareholding Ministers at least one month before the start of each financial year (ie, the end of May). Shareholding Ministers’ preference, however, is that SOEs provide their draft SCIs and business plans at the start of May to allow adequate time for meaningful review. If, for any reason, an

SOE considers that it cannot meet this deadline, it should contact COMU as early as possible.

Sections 14(2) and (3) of the SOE Act set out the information to be contained in each SOE's SCI, including the objectives of the group, the nature and scope of its activities and the performance targets by which the group may be judged in relation to its objectives. Each SOE's SCI should clearly identify the information required by these sections of the SOE Act, and make clear linkages between objectives and performance targets.

Shareholding Ministers expect the performance targets and measures in each SCI to be meaningful and related to the drivers of each SOE's performance. Once the business plan and draft SCI are received, officials prepare a report for shareholding Ministers outlining the key aspects of each SOE's future strategy. As part of this process, advisors will engage with the companies to clarify any questions arising out of the business plan and draft SCI. To facilitate this, it is expected that each SOE will submit with its business plan a full set of financial statements (including a statement of financial performance, statement of financial position and statement of cash flows) for the planning period.

Under the SOE Act, shareholding Ministers may comment on the draft SCI, which may include a request for further information or clarification on certain matters. This may be in the form of a letter or, if required, in a meeting between shareholding Ministers, officials and the board. The comment may also include an extension to the date by which the final SCI must be delivered to shareholding Ministers for tabling.

Boards are required to consider any comments by shareholding Ministers on the draft SCI no later than 14 days before the start of the financial year and deliver a final SCI to shareholding Ministers on or before the start of the financial year or such later date that shareholding Ministers have determined. The responsible Minister is required to table the final SCI in the House of Representatives within 12 sitting days of its receipt. The SCI should be made publicly available only once this has occurred.

Once tabled, COMU will make it public a copy of each SOE's SCI on the COMU website. SOEs are also encouraged to make their SCIs widely available. The business plan is not a public document and is not tabled. If the board of an SOE wishes to amend its SCI after it has been tabled, it must advise shareholding Ministers and consider any comments shareholding Ministers may have on the proposed modification(s). The SOE Act sets out the process for making amendments to an SCI during the year.

#### **4.3.6 SCI content expectation**

The board of each SOE is required to specify in the company's SCI the group's objectives, and the nature and scope of the activities to be undertaken. The

board of each SOE may wish to consider separately defining, in relation to the nature and scope of the activities to be undertaken by the group, the company's "core business activities".

In this context, shareholding Ministers consider that: a) the "nature and scope of the activities to be undertaken by the group" defines the boundary outside of which the group may not carry out any business; b) "core business activities" represents the core business-as-usual activities to be undertaken by the group in line with its core competencies, and any business activities to be undertaken by the group that are not core business activities should be within the nature and scope of the company's activities.

Ministers expect the board of each SOE to operate in such a way that it does not lose focus on the company's core business activities. This does not preclude expansion into non-core areas. SOEs are encouraged to diversify where they can demonstrate spill-over benefits and effective utilisation of core competencies. Ministers will clarify such expectations with individual companies as part of the annual business planning round.

India: Performance Evaluation tool: Memorandum of Understanding (MOU) system in SOEs

MOU system was initiated in 1986 following the ArjunSengupta Committee Report (1984). Ever since its inception it has been perceived as a practical solution to tackle various issues pertaining to PSEs and includes: i) widely held perception that the PSEs are less efficient than their private sector counterparts; ii) PSEs are unable to perform at efficient levels because of multiplicity of objectives; iii) Lack of clarity of objectives and confused signals imparted to the management followed by diluted accountability and iv) absence of functional autonomy.

The main purpose of the MoU system is to ensure a level playing field for the public sector enterprises viv-à-vis the private corporate sector. The management of the enterprise is made accountable to the government through a promise of performance. The government continues to have control over these enterprises through setting targets in the beginning of the year and by 'performance evaluation' at the end of the year (Public Sector Enterprise Survey, 2010-11). Performance evaluation is undertaken based on a comparison of the actual achievements and the annual targets agreed between the government and the CPSE. The target constitutes both financial and non-financial parameters with different weights assigned to the different parameters. In order to distinguish 'excellent' from 'poor' performance during the year is measured on a 5-point scale (Public Sector Enterprise Survey, 2010-11).

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**Table 1.** Summary of the performance of MoU signing CPSEs (numbers)

Rating	2006-07	2007-08	2008-09	2009-10	2010-11
Excellent	46	55	47	73	67
Very Good	37	34	34	31	42
Good	13	15	25	20	24
Fair	06	08	17	20	24
Poor	00	00	01	01	02
<b>Total</b>	<b>102</b>	<b>112</b>	<b>124</b>	<b>145</b>	<b>150</b>

Source: PSE, 2011

According to Trivedi & Vittal (1992), the MoU system will internalise the changing priorities of the government in a systematic way. In the absence of an objective method for performance valuation, there is a danger of extreme reactions which are either difficult to enforce or justify. Second, the emphasis is on achieving the 'target' for profit. The signal that is sought to be conveyed is that any slippage on the profit front is becoming increasingly unacceptable. If an enterprise commits a certain level of profit, it must ensure that it delivers that amount to the nation.

Financial performance has moved to centre-stage of MoU and policy. The main issue confronting policy-makers is to devise ways of internalising this policy goal with clear and unambiguous signals regarding what is expected in terms of financial performance (Trivedi & Vittal, 1992).

## 5. Implications and conclusions

It is evident that the New Zealand state-owned entities are categorised based on their objectives, thereby differentiating between the commercial and social objectives. The ownership policy of New Zealand is explained in the Companies act and SOE act of 1986. Infact, the clearly articulated ownership policies provides a background for prioritising SOEs' objectives and are instrumental in limiting the consequences of passive ownership or excessive intervention in SOEs' management. Likewise, the selection process of the members of the boards in New Zealand is a case point for its objectivity and transparency to the nomination process. New Zealand has adopted a comprehensive approach to board appointments, from soliciting, vetting and recommending candidates through conducting induction training after an appointment has been made. Crown Ownership Monitoring Unit manages this process by advising the bodies responsible for appointment (i.e., the Minister after approval by a Cabinet Appointments and Hours Committee, and confirmation by Cabinet). It is responsible for developing a long and short list of candidates (with

options) for consideration by the Minister; conducting due diligence on preferred candidates (including conflict of clearance, background checks); managing the cabinet approval process; and managing the formal appointment process. These type of settings provides a better platform for accountability.

On the contrary, Indian state owned companies are segregated based on cognitive activities and performance. According to Locke & Geeta (2013), 89 SOEs are identified by Government of India (GOI) out of the total 239 SOEs, to ensure financial autonomy based on their cognitive activities and performance and classified them into three categories: Maharatna, Navratna and Miniratna. Government has nominated these as being of strategic importance and having the potential to emerge as global players. Consequently, there could be issues arising due to multiplicity of objectives.

While the ownership policy in India is stated through the guidelines issued by the department of public enterprise which is the nodal agency of the central government. The company act of discusses the ownership policy in a general manner thereby missing the element of legitimacy and hence may not provide a proper setting for a better accountability. For instance, according to the Director General of Standing Conference of Public Enterprises, India, for a better efficacy and accountability an independent, impartial, sovereign body of the government as an owner to provide explicit ownership. What is happening is that even after 60 years, we do not have ownership policies. The article of association and memorandum of understanding we sign at the formation of an enterprise are basically broad parameters only. But what is the role and what are the responsibilities of the owners through the administrative ministry are nowhere to be found. Because of this we cannot evaluate the accountability of the administrative ministry. This concurs with Trivedi (1994).

He observes that one of the reasons for the poor performance of the Indian SOEs is that there are multiple principals with multiple goals. For instance,

Secretaries to the Government of India have to answer to a number of agencies and institutions of the State. In addition to the Parliamentary committees such as the Public Accounts Committee, newly created Standing Committees and Parliamentary procedures such as questions, motions and debates place pressure on SOEs. Senior Government officials have to deal with the Comptroller and Auditor General, enquiry committees and commissions, Prime Minister's office and the Cabinet Secretariat. Each of the above agencies considers it to be its duty to hold government officials responsible. Such arrangements are not readily reconciled with the idea of creating autonomous SOE that are charged with performance and have a Board which is held responsible. The need for multiple players to have a say comes at a very real economic cost.

Institutional arrangements for exercising the state's ownership rights are complex compared to international practice. In addition, a number of other governmental bodies have oversight, regulatory, and recommendatory roles.

According to Frederick (2011), the political interference in the selection process had inefficient outcomes in the long-term, resulting in excessive turnover, a lack of desired profiles on the board, or even stagnation due to lack of fresh faces or innovative persons.

The selection procedure of the Boards in India indicates lapses in the SOE policy. For instance, the boards in Indian companies are constituted by the ministry based on the selection made by the public enterprise selection board which are finally approved by the cabinet committee on appointments. The recommendations made by PESB have to be endorsed by the concerned administrative ministry before being considered by the cabinet committee on appointments. This system of selection procedure is cumbersome and deleterious for the healthy functioning of an enterprise. The reasons for this being so are many: one, the PESB normally forwards a panel of two three incumbents for the appointment. The ministry should be endorsing the name of the candidate who is first in order but the ministry could even recommend the second or third candidate. The ministry may even disagree with the panel and may ask fresh selections. The cabinet committee on appointment takes its own time to make the final decision of recommending the candidate to the cabinet. Prior to considering the name, vigilance report on the conduct of the candidate has to be furnished to the cabinet committee on appointment. If all this goes smoothly it takes about eight to twelve months before the appointment takes place. This is indicative of corporate governance issues in India.

Recently, Dr. U.D. Choubey, Director General, Standing Conference of Public Enterprises (SCOPE), has expressed his views<sup>16</sup> on independent directors

role in Indian SOEs. Independent Directors are key ingredients of corporate governance at the board level. They are supposed to be watchdogs or conscience-keepers sitting at the fence with no accountability and pressure from either the administrative ministry or functional directors. But in practice their loyalty lies with the administrative ministry so much so that we can brand them as 'dependable independent directors'. The fact is that a lot of lobbying goes into their appointment process, which results in a situation where there is a big gap between them and the functional area of an enterprise. The result is that they come to the board meetings unprepared and take interest in only agenda items which suit the interests of their appointing authority. This is a lacuna in the present system and he felt that the root cause is the selection system.

In order to avoid the agency costs arising due to political intervention it is suggested that the power to select independent directors to the boards should be completely vested in the public enterprise selection board (PESB). To avoid any conflict of interest, the administrative ministry should not be there in the search committee of the PESB nor be a votary to the selection of a particular candidate. The PESB should be given the powers of a constitutional body like their appointments committee of the cabinet (ACC) so that its selection of an independent director is final. Since this process may need parliamentary approval, we could look at a easier option where the PESB selects a candidate and sends it to the cabinet secretary for notification, avoiding the administrative ministry.

Therefore, the issues identified in the literature of SOEs which includes bureaucracy, political interference and Political Patronage continue to persist in India in spite of the corporate governance reforms. It is evident that the agency conflicts arising from four layers are evident in case of India while New Zealand case shows evidence of transparency and preferred settings for a better accountability and fits into the frame of OECD guidelines.

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