Article

MoU System in State-owned Enterprises in India: A Tool in Strategic Management

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Abstract

The role of state-owned enterprises (SOEs) in India has to be seen in the historical context. They have played an important role in the country's development. The Memorandum of Understanding (MoU) system introduced in these enterprises has gone beyond the original objective of grant of greater autonomy. While it has become a tool in strategic management today, it is riddled with some inadequacies that need to be removed. The article argues that a reformed MoU system will go a long way in enhancing the contribution of these enterprises to India's GDP.

Keywords

Performance contract, balanced scorecard, signalling system, offsets, company's vision, self-assessment

Introduction

The role of state-owned enterprises (SOEs) in India needs to be seen in the historical context. Industrial development under colonial India was 'a history of slow and arrested progress' (Lokanathan, 1943). Lord Morley, Secretary of State for India (1905–1911) is reported to have 'set his face against any attempt on the part of the [g]overnment to assist industrial development' (*ibid.*). The First World War (1914–1918), however, exposed the short-sightedness of such an approach as supplies of essential commodities from abroad to India were cut off, either wholly or partially. In the face of such a crisis, the iron and steel plant of JRD Tata, set up in 1911 in Jamshedpur, was an exception and 'stood the country in good stead during the war' (*ibid.*).

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The subsequent period between the First World War (1914–1918) and Second World War (1939–1945) saw some increase in the output of coal, cement, cotton textile and sugar, but that was also way behind the country's requirements. Indian industries continued to be heavily dependent 'on foreign sources for machinery, capital equipment and even for spare parts' (*ibid.*). Moreover, since the private corporate sector was dominated by the 'managing agency system' characterised by safe ventures, such as importers of machinery, traders and insurance agents, very little could be expected from them for industrialising the country.

It was this legacy of an industrially backward India that the rulers of free India inherited at the time of Independence. The Government of India, therefore, adopted the Industrial Policy Resolution in 1948. It also enacted the Industries (Development and Regulation Act) in 1951, which provided for 'industrial licensing' to ensure optimum utilisation of scarce capital. Those who got the licences were assured of government support by way of grant of land, easy approvals, long-term loans and tariff protection.

The Industrial Policy Resolution, adopted subsequently in 1956, made it further clear that 'the need for planned and rapid development requires that all industries of basic and strategic importance, or in the nature of public utility services, should be in the public sector'. 'The new public sector projects were given a corporate form with their own [b]oard of [d]irectors including people with business experience in the private sector as well as government officials' (Jha, 1986).

> Under such a regime which was essentially liberal and promotional, the 50's witnessed a phase of rapid industrialisation. The rate of industrial growth during the decade averaged 6.9 per cent per annum which was not only higher than the rate of growth in the first half of this century, roughly estimated at 2 per cent per annum, but also better than the rates in the subsequent decades which dropped to 4.2 per cent in the 70s. (*ibid.*)

The decades of the 1960s and the 1970s, however, saw an increase in controls affecting adversely both the private sector and public sector.

> One of the worst features of the proliferation of controls was that the consumers as a class, that is, the public at large, had to pay higher and higher prices for industrial products, as import licensing shut out external competition and industrial licensing and other restraints minimized internal competition and created a seller's market. (*ibid.*)

Administrative Reforms and Public Sector Enterprises

It was, therefore, suggested

> what is needed is a purposeful re-examination of the tools of economic management, of ways in which the community in its collective wisdom through the government in power and the administrative machinery at its disposal can help guide, encourage and energise economic development, and all those who contribute to it. (*ibid.*)

In respect to public sector enterprises, in particular, it was observed that '[u]nfortunately, a trend has developed for the assessment of the public sector's performance to be in terms of their compliance with procedures evolved and followed in government departments rather than in terms of fulfilling time bound targets' (*ibid.*).

It was in this background that the Government of India introduced the Memorandum of Understanding (MoU) system in Central Public Sector Enterprises (CPSEs)/SOEs in 1986. The MoU system is a 'performance contract' between the management of these enterprises and the administrative ministry. The ministry accordingly sets the target in the beginning of the year in return for 'grant of operational autonomy' to the management of these enterprises. The performance of CPSEs is subsequently evaluated at the end of the year against the target. The variable pay of board-level and below-board-level executives as well as those of the non-unionised supervisory staff of CPSEs is based today on this evaluation.[1]

MoU System in Central Public Sector Enterprises

The system of 'performance contract' in SOEs is in vogue in countries as varied as China, South Korea, Ghana, Morocco, Argentina, Brazil, Canada, Finland and the UK (Bennett, 1990; Lal Bahadur Shastri Institute of Management [LBSIM], 2013). A great deal of literature exists, reviewing the gains from the MoU system to SOEs. Most of these studies, however, ignore the different approaches to performance contract that influences the effectiveness of the MoU system. It is in this context, that the further discussion examines the MoU system in CPSEs in India which has been evolving over time.

Arjun Sengupta Committee Report (1984)

The Government of India introduced the MoU system in select CPSEs in 1986 based on the recommendations of the Arjun Sengupta Committee Report (2009). It was a medium-term contract between the CPSE and the administrative ministry, spanning over a period of five years that could be reviewed annually.[2] It prescribed, furthermore, select financial ratios for evaluating/measuring performance, namely net profit/net worth (for CPSEs in manufacturing sector), gross margin/gross asset (for CPSEs in services sector) and gross margin/gross sales (for CPSEs working under administered price regime). Accordingly, if the CPSE achieved the ratio 'x' or above it vis-à-vis the performance indicator, it was considered successful; if not, it was judged to have underperformed.

The Signalling System (1989)

MoU system underwent a significant change in 1989 based on the Pakistani and South Korean models of MoU.[3] Performance contracts, henceforth, became annual contract rather than medium-term contract between the CPSE and the administrative ministry. The new system, furthermore, provided for 'grading performance' based on pre-negotiated metrics of key indicators that were ranked on a five-point scale of 'excellent', 'very good', 'good', 'fair' and 'poor' (Table 3). Under this 'signalling system', the basic target (good) had to be decided first; the other targets followed from it with two targets above and two targets below the basic target.

Another novel feature of the new system was finalisation of MoU under the overall supervision of a third party, namely, the MoU Task Force that was independent of both the administrative ministry and the CPSE. However, as the new system did not indicate clearly the methodology to determine the basic target, it remained a contentious issue until it was decided that the basic target should be 'the maximum achievable under the given and anticipated circumstances including the company's past performance, with some comparative benchmarking, supported by relevant data, and in line with expectations of the government, the Five Year Plan, the Corporate Plan, and interests of the shareholders' (Department of Public Enterprises [DPE], 2012).

The Task Force was, furthermore, given the flexibility to fix the contiguous targets, that is, two levels above and two levels below the basic target. The targets finalised in the beginning of the year could not, however, be re-negotiated during the year and no concession was allowed for the exigencies of macroeconomic factors beyond the control of the management.

NCAER Study and Balanced Scorecard (2004)

The MoU system in CPSEs was further modified in 2004 based on the recommendations emerging from the study by the National Council of Applied Economic Research (NCAER) titled 'Revamping of the MoU System'. Essentially, it laid stress on choice of performance indicators and their respective weights. Allocation of weights to financial and non-financial indicators of company's performance was accordingly changed from 60:40 to 50:50.

With equal weights being given to these two sets of performance indicators, the MoU system got identified with the balanced scorecard (BSC), pioneered jointly by Robert Kaplan and David Norton (1996). According to the authors of BSC, however, 'Much more than a measurement exercise, the BSC is *a* management system that can motivate breakthrough improvements in such critical areas as product, process, customer, and market development' (Kaplan & Norton, 2011).

BSC is being used today by more than 50 per cent of global companies such as Apple, IBM, DuPont, Philips electronics and Bank of Tokyo. Corporate performance, on the other hand, has been evaluated traditionally based on financial parameters obtained from 'profit & loss statements' and 'balance sheets'. Such a reliance has been there due to the importance of physical and financial assets, which are tangible assets and easy to measure.

Corporate success for long was, moreover, observed to depend on low cost per unit of output ('economies of scale'/'economies of scope') and lower prices. Under the changed economic environment, however, characterised by short life cycle of products, the real drivers of growth for companies have come to be recognised as capacity to innovate, customer relationship and continuous improvement in internal processes. 'The BSC was the result of meeting this inadequacy in financial management'; it has brought into focus the non-financial parameters as key growth drivers.

Although the MoU system got identified with the BSC as a result of the NCAER study, it did not imbibe all the features of BSC as proposed by Kaplan and Norton (1996). It was, therefore, criticised for not fully implementing the BSC (LBSIM, 2013). The difference between the BSC approach suggested by Kaplan and Norton and that introduced by the DPE, Government of India is illustrated in Table 1.

The new approach of performance evaluation emerging from the study of NCAER, furthermore, subdivided the non-financial parameters into 'dynamic indicators', 'sector-specific indicators' and 'enterprise-specific indicators' (NCAER, 2004). These subdivisions are not there in BSC as articulated by Kaplan and Norton, which mentions instead the perspectives of customers, internal processes, and learning and growth (Table 1).

Since sector-specific and enterprise-specific indicators were loosely defined under the new system, they have been a source of perpetual confusion while implementing the MoU system in CPSEs. Allocation of equal weights to financial and non-financial parameters was subsequently criticised by a number of CPSEs, as it was found inappropriate and not fair to them.

The 'committee on the MoU System' constituted by DPE in 2012 dwelt upon the option of changing the weight given to financial and non-financial parameters from 50:50 to 40:40:20 (with 20 being assignable to either category, in full or part, as considered desirable on an enterprise specific basis). However, 'after detailed consideration, the committee opted in favour of the existing level of 50:50 for each major category financial and non-financial' (DPE, 2012).

It is worth mentioning that Kaplan and Norton do not favour equal weights being given to financial and non-financial parameters 'in all cases'. Their emphasis, on the other hand, is on bringing about a synthesis between the different perspectives of 'customer', 'internal processes', 'learning and growth', and 'financials' (Table 1). According to them, allocation of weights to different parameters ought to be customised vis-à-vis the particular strategy of the company.

Kaplan ad Norton, furthermore, see a cause and effect relationship between non-financial measures (lead factors) and financial results (lag factors).

Table 1. Different Approaches to Balanced Scorecard

Kaplan and Nortan		DPE	
Measurement Perspective Weight		Measurement Perspective Weight	
I. Financial Indicators	–	I. Financial Indicators	50%
II. Non-financial Indicators	–	II. Non-financial Indicators	50%
2.1 Value to Customers		2.1 Dynamic	(30%)
2.2 Internal Processes		2.2 Sector Specific	(10%)
2.3 Learning and Growth		2.3 Enterprise Specific	(10%)

Source: 'Balanced Scorecard' by Robert S. Kaplan and David Norton (1996) and various 'MOU Guidelines' issued by the Department of Public Enterprises, Government of India.

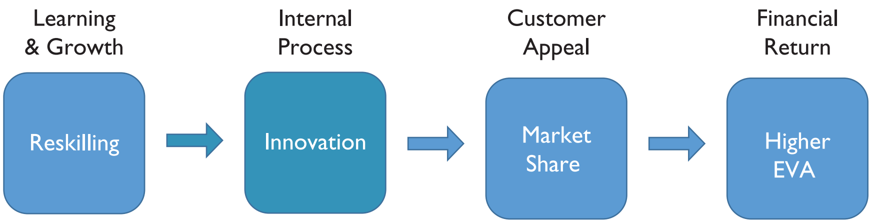


Figure 1. Interrelationship between the Four Perspectives of BSC

Source: Designed by the author.

According to them, 'A failure to convert improved operational performance into improved financial performance should send executives back to the drawing board to rethink the company's strategy or its implementing plans' (Kaplan, 1996).

The interrelationship between the different perspectives as envisaged by Kaplan and Norton may be illustrated as shown in Figure 1.

MoU as a Tool in Strategic Management

MoU system in CPSEs was originally introduced to grant operational autonomy to these enterprises. Over the years, it has gone beyond this simple objective and has evolved into a tool in strategic management (SM). SM is stated to have the three essential features of (a) strategy formulation, (b) strategy implementation and (c) strategy evaluation and recalibration (Jagiello & Jagiello, 2016). The MoU system in CPSEs incorporates all these features, as discussed further.

Strategy Formulation

In order to position the enterprise in tomorrow's world, every company needs to have a strategy. 'The first step in this direction is to come up with the company's vision for the future.' The MoU guidelines issued by the DPE to CPSEs require them to indicate clearly their visions[4] and missions. Some of the prominent CPSEs are known to employ the services of international consultancy organisations to help them build their vision.

Vision of a company is formed and formulated based on factors such as discovery of new markets (globalisation), mega (demographic/income) trends within the country, competition from rivals, technological changes or feedback of consumers. It may similarly be based on 'profit pool mapping' to find out the profit margins in related activities and to know the respective shares of each one of them in the industry revenue (Gadiesh & Gilbert, 1998). This could also be based on scanning and screening of opportunities and threats or based on sensitivity analysis vis-à-vis changes in interest rates, foreign exchange fluctuations and changes in commodity prices, etc. In a way, it is going beyond the short-term macroeconomic pressures of today.

Vision of the company may subsequently be translated into tangible objectives/goals/milestones to be implemented in phases. Each of the divisions of the company and their strategic business units (SBUs) may be requested to make their presentations vis-à-vis their proposals/plans/projects for achieving the vision. These plans/projects may subsequently be further examined from the point of view of their financial viability.

Once they have been found to be economically sound, they may all be integrated into one to give shape to the vision in the future. The vision has to be subsequently cascaded throughout the organisation to elicit the desired support of all the employees. This may also call for making the necessary investments and building the required capability within the organisation.

Strategy Implementation

The next step in SM is to decide the strategy to achieve the vision. BSC proves to be useful at this stage, and the strategy revolves around the four perspectives of customer, internal processes, learning and growth, and financials. Performance indicators against each of the four perspectives, in turn, may be selected as shown in Table 2 (Column 2; Kaplan, 1996). The related targets and enterprise-specific initiatives (projects) may subsequently be woven around these performance indicators/growth drivers, as shown below (Columns 3 and 4, Table 2).

The list of performance indicators shown in Table 2 is not exhaustive. According to Kaplan and Norton, 'The……performance driver measures on the BSC….should be subjects of intensive and extensive interactions among senior and mid-level managers as they evaluate strategies based on new information about competitors, customers, markets, technologies and suppliers' (Kaplan, 1996). BSC, in this respect, is not merely a mechanism for performance evaluation, rather a planning device, 'a tool in SM'.

Table 2. BSC Perspectives, Performance Indicators, Targets and Initiatives

Perspective	Performance Indicators	Basic Target	Initiative/Project Implementation
(1)	(2)	(3)	(4)
I. Customer	Market Share	30%	Enterprise specific
	Customer Retention	80%	--do--
	Customer Satisfaction	90%	--do--
II. Internal Processes	Quality	–	--do--
	Response Time	–	--do--
	Cost Reduction	–	--do--
	Innovation	–	--do--
III. Learning & Growth	Employee Satisfaction	–	--do--
	Information Availability	–	--do--
	Reskilling of Employees	25% per year	--do--
IV. Financial	Return on Investment	20%	--do--
	Growth in Economic Value Added (EVA)	10% per year	--do--

Source: 'Balanced Scorecard' by Robert S. Kaplan and David Norton (1996).

Under the extant MoU system in CPSEs, however, the performance indicators are all decided by DPE that have to be applied uniformly by the different groups of CPSEs. The MoU guidelines issued by DPE currently indicate performance indicators such as turnover, operating profit, leveraging net worth, dividend/PAT, PAT/net worth, dividend/net worth 'in the financial category' and capacity utilisation (for manufacturing CPSEs), quantity traded (for trading CPSEs), loan sanctioned (for financial CPSEs), production efficiency, project implementation and R&D 'in the non-financial category' (DPE, 2016).

There is, however, little or no linkage between the (enterprise specific) visions of CPSEs and the strategy being implemented. Moreover, while the extant MoU guidelines insist on providing the values of performance indicators for the previous five years, 'there is no suggestion for indicating the future values of targets for accomplishing the vision'. A good many CPSEs do prepare their corporate visions with a ten to fifteen year horizon with a rolling plan to review the vision every five years. The annual targets under the MoU system could, therefore, be integrated with the corporate vision of each CPSE for the next five years.

The role of DPE, under this new approach, should be to provide the necessary oversight. It may give up the practice of deciding the set of performance indicators for groups of CPSEs. 'The focus should instead shift to examining the vision of each CPSE, which the department may do in concert with the administrative ministry and the NITI Aayog'. Since the CPSEs may need to become 'global' for their survival and future growth, they may need to review and revise their earlier visions and missions.

Furthermore, the approach of using the MoU system to ensure compliance to various government directives such as 'financial orders', 'corporate governance' and 'corporate social responsibility', etc., needs to be given up as that dilutes the emphasis on SM. Figure 2 illustrates the linkage between vision, BSC, targets and initiatives (project implementation), as envisaged by Kaplan and Nortan.

One of the essential features of BSC is emphasis on measurements (scorecard), as it is pointed out 'what cannot be measured cannot be managed' (Kaplan, 1996). At the same time, 'emphasis on measurement also amounts to data gathering, hypothesis testing through reviews, reflection, strategic learning and adaptation' (Kaplan, 1996). Unlike the financial indicators, the non-financial indicators such as customer (value for money), and learning and growth are not easy to quantify. This may require building consensus around the measure or conceptualising new performance indicators that are measureable.

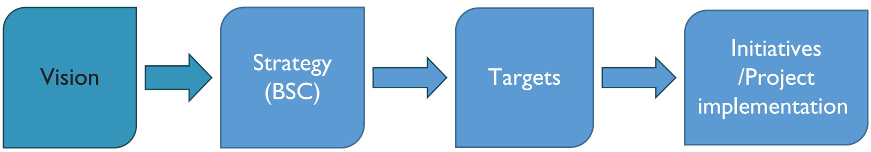


Figure 2. Linkage between Vision, Balanced Scorecard and Initiatives
Source: Designed by the author.

Strategy Evaluation and Recalibration

The actual achievement/progress made by CPSEs by the end of the year is evaluated against the targets set out in the beginning of the year. Most of the private companies review the progress/performance every quarter. They are also observed to make necessary changes in the targets in the light of macroeconomic developments beyond the control of management.

The possibility of reviewing targets in the case of CPSEs is, however, very remote as the exercise for finalising targets of CPSEs is coordinated by DPE, and the department can still afford to organise such review meetings for more than 200 CPSEs every quarter. At the same time, whenever the external situation changes for the worse or for the better, the relative performance of CPSEs also undergoes a big change. This nullifies the organisational effort and undermines confidence in the methodology of performance evaluation.

A way out from this dilemma typical to CPSEs is to introduce 'offsets' in the MoU assessment format with appropriate weights assigned to them in addition to the four perspectives of customer, internal processes, learning and growth, and financial return as articulated by Kaplan and Norton. The grade accorded to 'very adverse conditions' in respect to 'offsets' is accordingly one (1), at one end, and five (5) to 'very favourable conditions', at the other end, which are in reverse order of 'excellent' and 'poor' accorded to financial and non-financial indicators on the five-point scale. This is shown in Table 3.

Table 3. MoU Assessment Format (On the Five-point Scale)

		Targets				
Perspective/ Performance Indicators	Weight (%)	Excellent (1)	V. Good (2)	Good (3)	Fair (4)	Poor (5)
1. Customer	10–30					
(a)						
(b)						
2. Internal Process	10–30					
(a)						
(b)						
3. Learning & Growth	10–30					
(a)						
(b)						
4. Financial Return	10–30					
(a)						
(b)						
	Macroeconomic (External) Conditions					
Offsets	Weight (%)	Highly Adverse (1)	Adverse (2)	Normal (3)	Moderately Favourable (4)	Very Favourable (5)
1. Sector Specific	0–10					
2. Enterprise Specific	0–10					
	100					

Source: Designed and proposed by the author.

The advantage of introducing 'offsets' in the assessment format is that it compensates those who lose because of adverse conditions and moderates the composite score (weight × grade) of those who obtain windfall gains on account of external factors. The 'offsets', in turn, could be of two types, namely 'sector specific' and 'enterprise specific'. While sector-specific offsets will cover factors such as interest rate changes and foreign exchange fluctuations, enterprise-specific offsets will cover factors such as changes in commodity prices, local strikes and transport disruptions, etc.

These are factors outside the control of the management. These 'offsets' will, however, be different for different CPSEs, and will have to be indicated along with the financial and the non-financial targets by the CPSE, in the beginning of the year.

Conclusion

The Industrial Policy statement of 1991 brought about a paradigm shift in the treatment of public sector enterprises. A number of areas that were reserved exclusively for the public sector were opened to the private sector. The economic scenario in the country was also no more the same as in the early 1950s. Capital was not as scarce as before, and it was no more a case of a fledgling private sector dominated by the 'managing agency system'.

With entry allowed to private sector in areas reserved exclusively for the public sector earlier, competition in the market has intensified. This has led to higher investments and benefitted the consumers as exemplified in the telecom sector. Focus on non-financial perspectives of customer, internal processes and learning, and growth (technology) have become very decisive for ensuring healthy financial returns to CPSEs in the buyer's market.

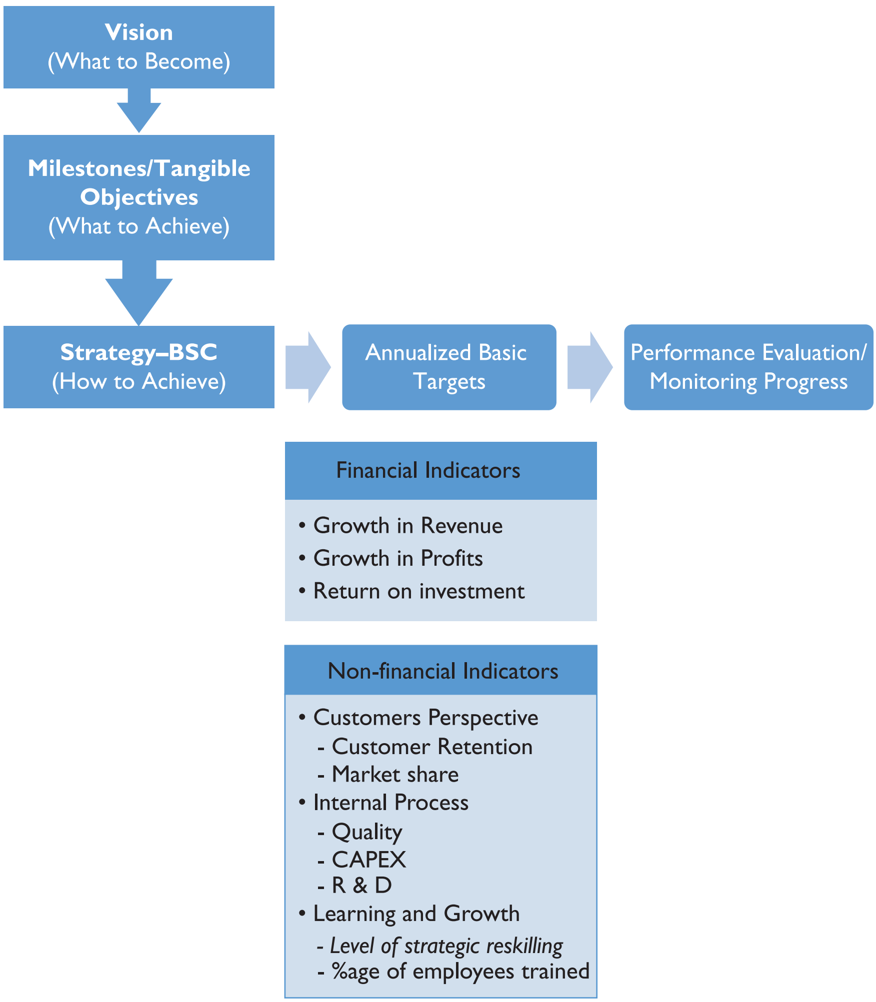
The SOEs in China have had a role in that country's rise as a global power. The CPSEs in India too have played an important role in the development of different sectors of the economy whether that be manufacturing, mining, services, infrastructure, or agriculture. Contribution of all the CPSEs to India's gross domestic product (GDP) currently stands at around 6 per cent, which can go up to 10 per cent with further improvement in their performance. The MoU system in CPSEs can play a significant role in achieving this goal.

The extant MoU guidelines issued by DPE to all the CPSEs incorporate the essential features of SM, namely (a) strategy formulation, (b) strategy implementation and (c) strategy evaluation and recalibration. However, since it is DPE (and not the CPSEs) that fixes the non-financial and financial indicators, and 'that too uniformly for groups of CPSEs', there is no linkage between the separate visions of CPSEs and the specific strategies to be adopted by each CPSE for achieving their visions.

In all fairness, the selection of performance indicators vis-à-vis non-financial and financial perspectives as well as allocation of weights to each one of them should be left to the CPSEs. It cannot be 'one-size-fits-all' as the performance indicators (growth drivers) have to be customised to the different visions of the CPSEs. The role of DPE may, therefore, be limited to providing the necessary 'oversight' with focus on formulation of the vision of the CPSE, which it may do along with the administrative ministry and the NITI Aayog.

The practice of using the MoU system to ensure compliance to various government directives such as 'financial orders', 'corporate governance' and 'corporate social responsibility', etc. should also be given up as that dilutes the emphasis on SM. Performance evaluation under the MoU system, moreover, needs to be seen as 'self-assessment' by the CPSE vis-à-vis the progress made in achieving the corporate vision.

Ironically, while the extant MoU guidelines insist on providing the values of performance indicators for the previous five years, 'there is no such suggestion in the [g]uidelines to indicate the future values of targets (besides the next year) for accomplishing the vision'. Figure 3 broadly provides the BSC framework for the MoU system based on the Kaplan and Norton approach; 'this includes the future projections for the next three/five years'.



2016–2017	2017–2018	2018–2019
X_1	X_2	X_3
Y_1	Y_2	Y_3
Z_1	Z_2	Z_3

2016–2017	2017–2018	2018–2019
R_1	R_2	R_3
P_1	P_2	P_3
I_1	I_2	I_3

2016–2017	2017–2018	2018–2019
S_1	S_2	S_3
20%	25%	30%
–Six Sigma for Quality Control –		
Q_1	Q_2	Q_3
–Contribution of Innovation –		
L_1	L_2	L_3
40%	70%	100%

2016–2017	2017–2018	2018–2019
T_1	T_2	T_3
M_1	M_2	M_3
O_1	O_2	O_3
K_1	K_2	K_3

Figure 3. Balanced Scorecard Framework
Source: Designed by the author.

DPE may also consider introducing 'offsets' in the MoU assessment format in addition to the four perspectives of BSC, as articulated by Kaplan and Norton. It would address the dilemma arising from the inability to reconsider the annual targets midway. The MoU system is indeed a very transparent method to reward and motivate the employees. Introduction of 'offsets' will go a long way in enhancing the fairness and robustness of the performance evaluation under the MoU system.

Quite often the usefulness of MoU system is questioned with regard to sick and loss-making enterprises. The inherent strength of BSC under the MoU system, on the contrary, is to bring about structural change in the company through redefining the vision of the company, and emphasising on the non-financial perspectives of customer, internal processes, and learning and growth. Such an approach is conducive to bringing about the required transformation of sick and loss-making enterprises.

Notes

1. As per the recommendations of the Third Pay Revision Committee (November, 2016), the variable pay or the performance-related pay (PRP) will have three components of (a) performance of the CPSE, (b) performance of the team and (c) performance of the individual as evaluated during the year, having the respective weights of 50 per cent, 30 per cent and 20 per cent, respectively.
2. MoU system in India was inspired by the performance contract ('Contracts du Program') introduced in France between the ministry and the public sector enterprise based on the recommendations of the report of the Simon Nora Committee (1967).

3. This model was developed by Professor L.P. Jones, Director of Public Enterprises Programme, Boston University on behalf of the World Bank. It is also known as the 'signalling system'.
4. 'Vision' statements of CPSEs get mixed up sometimes with 'values' of the company, which needs to be avoided.

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