MoU System in India: A Study on Corporate Governance Practices

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With the advent of globalization, the dominance of corporate entities has increased tremendously. In this paper we discuss about the corporations which are significantly controlled by the state through full, majority, or significant minority ownership and they are called the state owned enterprises (SOEs) (PWC, 2015). These SOEs have emerged as a strong global force and have proved this by their presence among the Fortune Global 500 companies growing from 9% in 2005 to 23% in 2014, including a greater presence in the top rankings (Laxmi, 2015). Some of the countries which are characterized by strong SOE presence apart from India are China, United Arab Emirates, Russia, Japan, Malaysia, and Singapore, to name a few. The SOEs in these countries are powerful tools to better the position of their country in the global economy.

Keywords: public sector, public enterprises, globalization, state owned enterprises, memorandum of understanding, corporate governance, performance contracts

Introduction

The state owned enterprises (SOEs) have gained the attention of the global community as they have made a significant place for themselves in the growth story of many countries. India is no exception to this trend. SOEs which are also termed as public enterprises (PEs) in India have spread far and wide and many SOEs belonging to different sectors have made their way into the global arena. The SOEs emerged stronger with the onset of global financial crisis in 2008. For the emerging economies especially those with huge natural resources, the SOEs became the saving grace and were the main source of capital. They forged ahead with internationalization despite odds and became an important source of international investment. Many developing countries today such as Brazil, China, Mexico, Ethiopia, Sri Lanka, to name a few have a sizable section of power generation, transport and communication and irrigation systems belonging to the SOE sectors under the state ownership. For example, in India, Nigeria, and Ghana more than 90% electricity generation is done by the SOE sector which is a benchmark in itself (PWC, 2015).

In this paper, we attempt to understand two vital policy elements which are under implementation in Indian SOEs—the system of MoU (memorandum of understanding) and corporate governance. The MoU is a performance enhancement tool used in SOEs to aid in performance improvements, while corporate governance is a policy framework of the government, which helps in creating an enabling environment for business in India and the provisions of the framework are applicable to the SOEs. Both these interventions bring the SOEs on par

with an international business organization as it facilitates the SOEs to strengthen their internal processes, enhance performance accountability and promote transparency mechanisms while making the SOEs ready for work with other enterprises in the global arena.

SOEs (PEs) in India

SOEs in India were established during the post independence era and have since played a very critical role in growth and development of the country. They have been instrumental in promoting a new socio-economic order wherein the natural resources of the nation have been utilised in a transparent, accountable and participative manner for benefit of all its citizens. From the very beginning since their inception PEs were established in strategic key sectors like roads, railways, telecommunications, defence, power etc., which were vital for economic regeneration of the country and these sectors were entrusted to the public sector. Private sector has also been provided their due in the growth and development of the country from time to time. Gradually, the role and importance of public enterprises changed considerably from being mere tools of fulfilling social objectives to being growth engines and contributing to economic prosperity of a nation. While there were some inherent problems that went along with the working of these enterprises especially their large size and multiple control and accountability points created major hurdles in their operational decision making and governance processes, there were some global best practices available during the time when the Indian government started looking for solutions to fix these problems (Mishra & Geeta, 2015).

There are about 250 central public sector enterprises (CPSEs). Majority of these CPSEs, including Maharatnas, Navratnas and Miniratnas, are earning profit and have improved their financial performance over the years. In the context of the policy of the government to grant more autonomy to the CPSEs and encourage them to access the capital markets for their fund requirement, Corporate Governance has become even more important. Under the recently introduced Maharatna Scheme, CPSEs are expected to expand international operations and become global giants, for which effective Corporate Governance is imperative (Mishra & Geeta, 2015).

Reforms in Indian SOEs

The Indian government made consistent efforts to enhance the performance of SOEs and many reforms have been ushered in from time to time. The two major reforms which swept the Indian SOEs include: (1) the system of MoU (Memorandum of Understanding or the Performance Contracts); and (2) the introduction of Corporate Governance practices.

The MoU system was introduced in SOEs due to the recommendations from the Arjun Sengupta Committee report in 1984 which highlighted the importance of MoU system for enhancing the performance of SOEs. There were some best practices globally available with the performance contracting or MoU system. During 1960s, the French government experimented with Performance Contracting (PC) system as a tool to improve the functioning of SOEs. The French model of performance contracting system with necessary modifications was adopted by countries like Bangladesh, China, Korea, Pakistan, Sri Lanka, Ghana, Gambia, Brazil, Argentina and many others. This was the time when the Indian government faced a lot of trouble in managing performance of SOEs and the expectations from them were also increasing. A high level Committee known as the Arjun Sengupta Committee was set up in 1984, to analyze the performance of SOEs, and identify problems that they face and suggest measures for improving their functioning. The Committee observed that the SOEs increased steadily in terms of numbers and spread all over the country and diversified from their focus on basic and heavy industry sector to areas of consumer goods, electronics, tourism and others (Mishra &

Geeta, 2015). Though there was a positive growth in terms of social objective, the fact remained that these enterprises were not performing well in terms of revenue generation and profits which became a matter of concern. The system of MoU was adopted by government of India in mid-1980s to streamline performance of SOEs (Mishra & Geeta, 2015).

A survey conducted by Price Waterhouse Cooper's CEO Pulse survey which took the views from CEOs of private sector indicated that they believe that government ownership has advantages in certain circumstances for, e.g., furthering social outcomes, providing physical infrastructure and creating stability in times of crisis within and across supply chains. But at the same time they had a view that there is a risk that state ownership can destroy value if best practices in ownership and management are not applied: of most concern to CEOs in our Pulse survey are issues of corruption, bribery and inefficiency.

The MoU is a mutually negotiated agreement between the management of the SOEs and the Government of India/Holding SOE. The MoU system involves goal setting in Financial and Non Financial areas and performance evaluation of these goals. A high powered committee under the Cabinet Secretary oversees the functioning of this system. The objectives of MoU are to improve the performance of SOEs by increasing autonomy and accountability of management; fixing of targets in accordance with the goals and objectives of SOEs; enable performance evaluation through objective criteria and provides a mechanism of rewarding and incentivizing performance. The MoU system was started with four SOEs signing MoU in the year 1986-1987 increased its coverage to 196 SOEs in the year 2012-2013. In the year 2012-2013, as per the performance evaluation report, 75 SOEs were rated excellent, 39 SOEs were good, 38 SOEs good and 36 SOEs poor and 2 SOEs were fair (Crane & Matten, 2007).

Box: 1: The highlights of the current MoU system:

MoU is an annual assessment method;

It's a performance agreement between the enterprise and its concerned administrative ministry;

Main criteria for assessment of performance are financial and non-financial parameters;

Targets are set at the beginning of the year (both financial and non-financial) based on which the enterprises are evaluated at the end of the year;

Assessment is done on a 5 point rating scale;

An institutional machinery in place to oversee the implementation of MoU;

Incentives linked with the MoU performance (PRP).

Figure 1. MoU & CG Reforms in India SOEs.

Emergence of Corporate Governance

With the advent of globalization and with the control of the government on market regulation slowly reducing, the element of mistrust crept in and the shareholders were seen to be losing trust and clearly there was a greater need for accountability (Narayana Murthy, 2000). There were a series of incidents which took place in the year 2002 in the US which further led to the drop in trust:

- (1) WorldCom (phone company)—inflated profits and financial misappropriation;
- (2) Enron (Energy firm)—millions of dollars were made by its executives, supported by Anderson its accounting firm which facilitated by destroying papers/evidences;
- (3) Dynergy (Energy firm)—got embroiled in accounting fraud;
- (4) Adelphia (Communication firm)—funds siphoned by founder family members;
- (5) Peregrine System (Software firm)—overstated revenues;
- (6) Rite Aid (Drugstore)—embroiled in accounting fraud.

All these incidents led to the emergence of contemporary corporate governance which formally started in 1992 with the Cadbury report, which was primarily to protect weak and widely dispersed shareholders against self-interested Directors and managers. A Committee chaired by Adrian Cadbury was set up in UK to study the working of company boards and accounting systems to mitigate corporate governance risks and failures. The Cadbury report is also known as a report on *Financial Aspects of Corporate Governance*. The report's recommendations have been used to varying degrees to establish other codes such as those of the European Union, the United States, World Bank, etc..

The other major milestone has been the adoption of Sarbanes-Oxley Act, informally referred to as Sarbox or Sox, by the federal government of United States. An attempt was made to legislate several of the principles recommended in the Cadbury and OECD reports. The United Kingdom took punitive measures against companies which indulged in financial frauds. The Sarbanes Oxley Act was passed which mandated that the CEO and CFO should swear in front of the notary that their annual and quarterly statements contain no untrue information. The CEO and the CFO has to certify their financial statements of their companies. Primarily concerned with public listed companies, i.e., those listed on a Stock Exchange.

The Indian businesses were in no way untouched by these developments and we saw many scams coming out in open:

- (1) Harshad Mehta (stock exchange)—a former stock broker from Mumbai, India, who was convicted for his involvement in the Indian stock market manipulation scam;
- (2) Ketan Mehta—a former stock broker from Mumbai, India, who was convicted for his involvement in the Indian stock market manipulation scam;
- (3) Ramalinga Raju (IT company)—was the chairman of Satyam computers limited and was convicted for misappropriation of funds.

The Government of India set up many Committees to recommend best practices to be adapted by businesses to bring in greater accountability, transparency and improve corporate governance. Some of the key committees that were set up Government of India include:

- (1) The Confederation of Indian Industry (CII) set up a National Task Force Chaired by Rahul Bajaj in 1997;
- (2) Security Exchange Board of India (SEBI) set up a task Force in 2000 chaired by Kumara Mangalam Birla;

(3) Security Exchange Board of India (SEBI) set up another task force in 2003 chaired by Narayana Murthy;

(4) Confederation of Indian Industry (CII) set up a National Task Force Chaired by Rahul Bajaj in 2009.

Box item: 2: Excerpts from the Report on CG

A high level committee was constituted by Security Exchange Board of India to look into the need for corporate governance practices and facilitating global business. The highlights of committee report: “Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure”. (Source: Kumar Mangalam Birla Committee Report, 2000, SEBI, India)

The Department of Public Enterprise (DPE) in the Government of India issues guidelines on Corporate Governance with the objective that the CPSEs follow the guidelines in their functioning. The main objective is that the proper implementation of these guidelines would protect the interest of shareholders and relevant stakeholders. The DPE issues guidelines on various crucial aspects of corporate governance including composition of Board of Directors of Central Public Sector Enterprises (CPSEs), professionalizing Boards by inducting adequate number of non-official Directors, setting up of Audit Committees, remuneration committee, disclosures, developing and implementing risk mitigation plan, disclosures, annual reporting, etc..

A legal framework has been developed by Indian Government to promote corporate governance practices in India. The Companies Act of 2013 is an Act of the Parliament of India which regulates incorporation of a company, responsibilities of a company, directors, and dissolution of a company.

- (1) The Act introduces significant changes to the composition of the boards of directors;
- (2) Every company is required to appoint 1 (one) resident director on its board;
- (3) Nominee directors shall no longer be treated as independent directors;
- (4) Listed companies and specified classes of public companies are required to appoint independent directors and women directors on their boards;
- (5) The Act for the first time codifies the duties of directors;
- (6) SEBI amends the Listing Agreement (with prospective effect from October 01, 2014) to align it with CA 2013.

The Act requires companies to have the following classes of directors (see Figure 2).

Figure 2. Types of Directors as Mandated by the Companies Act, 2013 of Government of India.

Corporate governance has become an important factor in managing organizations in the current global and complex environment (see Figure 3).

Figure 3. Key Principles of Corporate Governance.

MoU & CG: Complementary Systems

The MoU system was adopted at a time when the SOEs in India were facing the existential challenge and the Government was looking out for a mechanism to salvage the SOEs out of trouble. Therefore, MoU/PC system was adopted as a strategic tool to bring the enterprise working closer to the international standards. While corporate governance came about as a requirement due to the extent to which SOEs were going as a global force and many, if not most, large SOEs were actively engaged in international business. Therefore governments started pursuing explicit policies of SOE internationalization, to be able to compete with firms in an international space. The SOEs have made great strides to adapt internationally accepted governance practices and processes. We try to analyse and examine some of the key features of both these systems and how they have complimented each other in improving the functioning of SOEs and making them truly global.

Strengthening Organizational Performance

The Government of India realized that despite the important achievements of the public sector in terms of increase in production, development of strong industrial base, enhanced technological skills, all the contributions and achievements of the SOE sector to the Indian economy and Indian manufacturing, the overall performance of the various enterprises remained unsatisfactory and failed to fulfill some of its main objectives namely, generation of resources and financial profitability. The SOEs were expected to generate resources through manufacturing and other activities to further establish more industries. But they were unable to fulfill

this demand to the expected level. Financially, the SOE sector was expected to be a significant source of revenue for the state, revenue, which would in turn be used by the government for further development of fresh fields, which it did not fulfill.

MoU was introduced as a tool for the SOE to plan its performance strategy and develop appropriate measures for self-assessment at the end of the year. With this tool the SOE was equipped to plan its performance based on its capacity, external environment and resources available. It also helped the SOE to set measurable targets and reward managers for good performance at the end of the year. The MoU system helped SOE to identify issues at the operational level which contribute to the non-performance of SOEs and contribute for non-achievement of targets. By identifying these key challenges the SOEs improved their efficiency and performance and became more competitive.

In the complex global environment, corporate governance is an important factor in managing organizations. It deals with the set of processes and structures which control and direct the SOEs. The corporate governance principle desires that all the various stakeholders involved in an SOE including shareholders, employees, managers, suppliers, lenders, government, people at large have to be taken along in the process. The Government has brought in necessary laws to make corporate governance an integral part of an SOE which will help to bring them on par with the international processes of various firms and help to revitalize public sector companies by initiating measures for improving corporate governance mechanisms, brining in greater accountability and transparency and improving human resource management, technology up-gradation, etc..

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Strengthening Accountability Mechanisms

Corporate governance is about maintaining an appropriate balance of accountability between three key players the corporation's owners, the directors whom the owners elect, and the managers whom the directors select. The system of corporate governance provides for an overarching framework for doing business with enhanced accountability, transparency and participation. It enables accountability among various stakeholders such as the board, managers, shareholders and other stakeholders who participate in the working of SOEs and it thereby specifies the distribution of rights and responsibilities among those different participants in the corporation. It also spells out the rules and procedures for making decisions on corporate affairs. Therefore corporate governance is the acceptance by management of the inalienable rights of the shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the Management of the Company" (Narayana Murthy, 2000). This clarity provides for clearer accountability roles and more transparency in the functioning of the system.

The system of MoU was set up with the idea of increasing the accountability of SOEs for their performance in the form of a signed MOU. This MOU was to be signed between the enterprise managers and the administrative ministry concerned before the commencement of the financial year. The system of MoU came about as a tool which could provide the top management to bring in greater professionalism to their approach in managing their enterprise. The MoU system mandated enterprises to develop a strategic performance plan for 5 years based on the benchmarks available in the sector nationally and internationally. It also mandated the SOEs to look at their previous year's performance and plan for better results.

Disclosure and Transparency

As per the corporate governance requirements, the SOEs are required to share the financial information and other crucial information necessary for the investor to decide on his investments. With a strong MoU system, it is much easier for the SOE to be able to upload information on their websites and other means of communication. The Key elements of CG-Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

More and more business organisations are attaining a global edge and expanding in size. The companies listed on stock exchange have been forced to disclose mandatory information in their annual reports as set out by the statutory requirements. Reporting information voluntarily has become a norm for large companies. In fact, a large proportion of corporate disclosures made through annual reporting concern an agenda of visualising the company's core values, mission statement, business concept, and social responsibility. Annual reporting plays a central role in legitimising the company's existence.

Traditionally the main medium for communicating Corporate Governance (CG) practices has been through company annual reports. The internet provides an additional communication tool to augment traditional corporate reporting practices. Internationally, web-based communication has been promoted to enhance traditional communication practices by "enabling equitable access to information for all interested stakeholders. A strong, informative and transparent system of corporate disclosure is of paramount importance for the efficient and effective allocation of resources as well as integrity of financial markets. High-quality corporate disclosure helps investors and other capital market participants by enabling them to make proper assessment of the potential risks and rewards of alternative investments. Well-informed investment decision-making by capital market participants leads to efficient allocation of capital, which promotes productivity and economic growth.

Accountability requires not only good transparency, but also an effective means to take action for poor performance or bad decisions. More and more business organisations are attaining a global edge and expanding in size. The companies listed on stock exchange have been forced to disclose mandatory information in their annual reports as set out by the statutory requirements. Reporting information voluntarily has become a norm for large companies. In fact, a large proportion of corporate disclosures made through annual reporting concern an agenda of visualising the company's core values, mission statement, business concept, and social responsibility. Annual reporting plays a central role in legitimising the company's existence.

Improving Professional Performance Standards

One of the expectations from the public sector enterprises was that they would operate on the lines of a

private business and generate revenue which could be further invested in growth and development. The PEs were not successful as commercial ventures and so could not augment the revenue stream of the government. Efficiency in operation was an expectation that was not fulfilled by the PEs where both commercial and non-commercial enterprises saw a deterioration of efficiency.

There were many reasons for the failure. The SOEs were not provided with the freedom for operational decision making and this freedom was curtailed in a lot of cases or there was interference from the government in an unofficial manner. There were three essential questions raised regarding the public sector: (1) why the state was operating PEs; (2) What was expected from the PEs in the context of the Indian economy; and (3) How they were to operate in order to meet the expectation of the State.

The Industrial Policy Resolution 1991 suggested for enhancing autonomy to SOEs for taking speedy decisions for SOEs to be successful, decentralization of power and authority of SOEs along the line of a business or a private company was also suggested as one of the key measures of reforms. This led to the introduction the policy providing SOEs with the largest possible measure of freedom in their functioning and operations for improving their performance on lines of private businesses. Financial and administrative freedom was given to SOEs based on the nature of profitability of the enterprise.

Enhancing Organizational Credibility

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The public sector was facing issues like multiple accountability channels, information asymmetry, lack of autonomy and quick decision making, red tape and so on. The MoU system provided a level playing field for both the enterprise managers and ministries to negotiate the performance targets. There were also other problems of information asymmetry between the SOE and the government which the MoU system attempted to correct. One important expected change that came about with MoU was that SOEs were granted increased decision making authority over resource allocation, including cross-border mergers and overseas acquisitions. In addition, the authorities were expected to set up investment holding companies, introduce performance-based compensation schemes and—for SOEs deemed to be in non-sensitive sectors—allow non-state investment in government controlled firms.

The three basic components of MoU system are—Performance Information System, a Performance Evaluation System and a Performance Incentive System. The Arjun Sengupta Committee report recommended the need for a strong Management Information System (MIS).

The system of MoU has been under implementation since early 1990s and has facilitated the enterprises to develop information regarding their own firm and has also given them a reason to benchmark their own performance with similar companies across the globe and learn best practices from them. MoU has over the last many decades created the culture of performance orientation and professionalism and have tuned the SOE managers to be motivated and performance driven, thus giving them a level playing field in the international arena.

More and more SOEs are entering the global arena and there is a pressing need for companies to adapt international standards of governance and organizational systems. Corporate governance is one such requirement that Indian companies are fast adapting so that they will be able to compete and collaborate with the international firms. According to the Transparency International Survey, India has the most transparent companies while Chinese firms are the most opaque. The survey, released by the Transparency International on Monday, covered 100 companies in 15 emerging market countries that also included Brazil, Mexico and Russia. India led the way, with all 19 of its companies in the study achieving a score of 75% or more in being open about their company structures and holdings which was attributed to the country's Companies Act (2016).

The Transparency International study took into account three different ways in which companies can address corruption. These included the reporting of anti-corruption programmes such as policies to ban bribes or "facilitation payments", the disclosure of company structures and holdings, and the disclosure of key financial information in each individual country where they operate, such as tax payments. Transparency International researchers said this information was gathered from corporate websites and other publicly available sources.

Summing up

The adoption of MoU as a tool to enhance performance of SOEs provided the much needed professional approach to the functioning of these enterprises. It provided the environment much needed by the SOEs to strategize, plan, organize, measure and incentivize good performance. During the time when the SOEs faced intense competition from the private sector, this system provided the much needed introduction of performance culture usually adopted by a private sector firm and thus set in the change of SOEs and made them more competitive and result oriented. The MoU system has grown over the years by tuning into mechanisms like balanced score cards and other progressive techniques.

The introduction of corporate governance for the SOEs provided an overarching framework for managing the enterprises in a global arena. More and more SOEs were getting opened up to global competition and with the companies getting listed on the stock exchanges they had to make themselves more investor friendly and opaque. The companies listed on stock exchange were mandated to disclose in their annual reports as set out by the statutory requirements. With the introduction of corporate governance in SOEs a strong, informative and transparent system of corporate disclosure was brought in which is of paramount importance for the efficient and effective allocation of resources as well as integrity of financial markets. High-quality corporate disclosure helps investors and other capital market participants by enabling them to make proper assessment of the potential risks and rewards of alternative investments. Well-informed investment decision-making by capital market participants leads to efficient allocation of capital, which promotes productivity and economic growth.

Both the systems—MoU and CG systems contributed in a very holistic manner and have made Indian SOEs ready to penetrate the global competitive space.

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