

Implementation of Memorandum of Understanding (MOU) and Performance Trajectory of Public Sector Enterprises (PSEs) in India

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ABSTRACT

At the time of independence Indian economy was pre-dominantly agrarian in nature. There was little industrial presence in the country. The policymakers of independent India favoured creation of public sector as a tool for economic development through industrialisation. After the announcement of Industrial Policy Resolution 1956, the public sector saw massive growth in terms of investment and diversification. However, by the early eighties there was clear realisation among the policymakers that public sector as whole was unable to generate adequate surplus due to inefficiency which had set in due to numerous factors. Learning from the experiments of other countries, Arjun Sengupta Committee was formed in mid-eighties to suggest measures to improve the working of the public sector enterprises. Based on its suggestions, Memorandum of Understanding (MOU) system, that afforded more autonomy to the Public Sector Enterprises, was introduced in the late eighties. The MOU system that was introduced with just four PSEs in 1988 gradually expanded its scope to cover almost entire universe of the public sector in the next two and a half decades. The MOU system has also undergone many changes over this period. This paper is an attempt to trace the evolution of the MOU system in India and expansion of its scope over a period of two and a half decades. The paper also traces the trajectory of macro-level performance of the PSEs and attempts to assess whether the movement in the performance of Public Sector Enterprises (PSEs) as a whole has generally moved together with the expansion of the MOU system or whether there is a need for deeper analysis to explain the deviations, if any.

Keywords: Public Sector Enterprises; Memorandum of Understanding, Economic Reforms, Industrialisation.

INTRODUCTION:

The Public Sector in India was an initiative by the policy makers after the attainment of India's Independence in 1947. At the time of independence Indian economy was predominantly agrarian in nature with little industrial presence. Private sector was also not strong enough to take up projects of risky nature. Hence, it was up to public sector to take up developmental activities irrespective of the risk involved namely heavy investment, low returns, and long gestation periods. The aim was to promote speedy industrialization and rapid economic development in the country.

The Industrial Policy Resolutions (IPR) of 1948 and, more importantly, Industrial Policy Resolution-1956 laid the strong foundation for the public sector in India with an aim to allow it to grow to the position of commanding heights of the Indian economy. Under the IPR 1956, the public sector got a strategic role in the economy and seventeen industries were reserved exclusively for it. As a result, many of these enterprises successfully expanded production, opened up in new areas and built up a reserve of technical competence in a number of areas. In the 1960s and 1970s, PSEs got much importance on the social ground. Government aimed for growth with equity and justice. Hence, after the initial concentration of public sector investment in key areas,

public enterprises began to spread into other areas of economy, including non-infrastructure and non-core areas. However, in the early 1980s, PSEs started facing serious criticism as its inefficiency started coming to the fore. The government realized, after about four decades of economic planning, that the opportunity cost of economic resources being locked up in public enterprises was quite high. Public sector Enterprises were not able to generate resources for financing other developmental programs. These criticisms and rising fiscal imbalance forced the government to review the existing development strategy and the process of performance evaluation started assuming importance.

Memorandum of Understanding (MOU) was introduced as one of the mechanisms to address this issue. Starting from 1988, when four PSEs signed MOU with their respective ministries, almost the entire universe Central Public Sector Enterprises are now under the ambit of MOU system.

Against this understanding, the present study attempts to trace the macro-level performance trajectory of Public sector Enterprises with the expansion of MOU system.

This paper is organized as follows: the following section provides a brief review of literature related to impact of MOU on the performance of PSEs. The next section discusses the approach of the paper along with the methodology and data sources. The succeeding section reviews in a little detail the evolution and Expansion of MOU system in India. In the final section, macro-level performance of PSEs have been traced and analysed in the post-liberalization period. In the last section conclusions have been made.

REVIEW OF LITERATURE:

This section takes a look at the discussions on the issue at hand in earlier studies. The brief outline of some important studies relating to Memorandum of Understanding (MOU) has been detailed as below:

Trivedi (1991) states that policymakers initiated reform measures such as disinvestment and MOU due to non-delivery of expected benefits by the PSEs as envisaged by the policymakers during the second five year plan. Comparing the two, he says, disinvestment involves privatization of public assets, while MOU, on the other hand, brings about changes in the management of PSEs on the lines of a private enterprise. Disinvestment measures are based on the premise that ownership per se is the problem whereas MOU attempts to correct the control mechanism used by governments to manage a PSE. MOU and disinvestment can be applied as complementary measures. To fetch higher value on disinvestment, an MOU arrangement can be initiated in a PSE before divesting it.

Kumar (1994) says MOU system facilitates achievement of objectives by granting autonomy to the management. MOU system has brought about better focus in the working of the PSEs. PSEs have now more clarity of their objectives. Their performance is now linked with incentives. Inter-PSE comparison is also more convenient as MOU takes into account both commercial and non-commercial criteria of performance in static as well as dynamic aspects. For this, he offered certain strategies for turnaround of loss-incurring PSEs by suitably modifying the MOU structure. A PSE can only serve the public if its performance is improved.

Naik (2001) has enumerated different measures introduced to reform the PSEs. Memorandum of Understanding is one among them. He observes that by 1993-94 almost half of the PSEs were under MOU arrangement; however their financial performance saw deterioration. Author attributes this deterioration to increasing competition from domestic private companies as well as MNCs.

Ganesh (2001) observes that the "MOU" system, introduced to revitalize the public sector units, did not influence the performance of PSEs.

Vithal (2001) observes that MOU system helps provide clarity of goals to the lower level managers and employees by linking the internal incentive schemes to their performance. MOU system eliminates the multiplicity of objectives.

Nagaraj (2005) observes that profitability gained increasing importance in the measurement of performance of PSEs only after governments all over of the world started facing difficulty in managing the burden of loss-incurring PSEs on their budget deficit. India faced the same situation. This is evident from the importance attached to financial performance ratios in the Memorandum of Understanding (MOU). By 1993-1994, 50% weightage was accorded to financial profitability in the composite score evaluation of targets set under MOU, by almost all PSEs signing MOUs.

Raj (2012) states that Indian business conditions have changes after economic reforms. Hence, government is considering new guidelines in keeping with changed business environment in order to help India's top state-run companies to meet their investment targets. The author suggests grant of greater operational flexibility in cases where MOUs have high targets. In the case of Maharatnas and Navratnas, he proposes to have a review and appeal mechanism for revision of MOU in case there is a change in the business conditions. It has also been

suggested that investment plans provided by the PSEs should also be incorporated in the Memorandum of Understanding and that should be part of the appraisal.

Shantanu (2012) opines that the Memorandum of Understanding (MOU) plays a crucial role for nearly 200 profit-making central PSEs such as ONGC, Indian Oil, Coal India, NTPC, etc. MOU mechanism ensures autonomy to PSEs, at the same time depending upon the achievements of the target, performance-related pay goes up. The major challenge before the government is bringing loss-incurring PSEs into the fold of the MOU system. For this purpose, the department of public enterprises (DPE) has formed a working group. The panel is exploring the possibility of applying different MOU formats for different categories of CPSEs. Panel also explores whether more operational flexibility could be given to Maharatna and Navaratna CPSEs while setting targets.

Mohapatra (2012) has described the role, purpose, and usage of the MOU system. Based on the Arjun Sengupta Committee Report (1984), the MOU system was first introduced in India in 1986. He observes that the MOU system did help public enterprises; it was corroborated by the profitability of MOU-bound enterprises.

SIGNIFICANCE OF THE STUDY:

After independence, the policymakers emphasised the expansion and growth of public sector as a strategy for the rapid development of the country. Public Sector Enterprises saw major growth in 1960s and 1970s. However, by the early 1980s, it was increasingly clear that PSEs were unable to generate adequate surplus to augment capital formation in the country. The Arjun Sengupta committee report, as early as 1984 suggested the possibility of introducing an MOU between the administrative ministry and the managers of public enterprises. First MOU was signed by four Central Public Sector Enterprises in 1988. This paper tries to analyze the macro-level performance trajectory of Public Sector Enterprises along with the expansion of MOU system and attempts to establish impact of MOU on the performance of PSEs.

OBJECTIVES OF THE STUDY:

Public enterprises in India operate at three levels of administration—center, state, and local government. Public sector comprises administrative department (offices and other bodies of the government), departmental enterprises (railways, post and telecommunication), and non-departmental enterprises (financial and non-financial enterprises, with 51% of government equity). The scope of the paper is limited to PSEs owned and managed by the central government. In the light of this background, the present study has the following main objective:

- To analyze the macro-level performance of PSEs' along with the expansion of MOU system.

DATA SOURCE:

This study collected data from various secondary sources, namely, Public Enterprises Survey (Vol. 1) by the Department of Public Enterprises; National Account Statistics by the Central Statistics Organization; Economic Survey by the Ministry of Finance; Ministry of Disinvestment, www.divest.nic.in; various Annual Reports; and Research and Development Statistics by the Department of Science and Technology. The period of study is broadly from 1988-89 to 2015-16.

METHODOLOGY:

The analysis concentrates on those enterprises where the level of equity holding of the Government of India has been more than 50%. The technique of trend analysis has been extensively used in analysing the performance pattern of PSEs. Inferences have been drawn on the basis of co-movement of the variables over the period of analysis.

Evolution of Memorandum of Understanding in India:

The concept of Memorandum of Understanding (MOU) has been designed to provide flexibility and autonomy to Public Sector Enterprises (PSEs) such that it facilitates them in pursuing the objectives and purposes, for which the enterprises have been set up. The rationale for MOU could be derived from principal/agent theory. The principal, administrative ministry on behalf of real owners - the people, can only observe outcomes and cannot measure accurately the efforts expended by the agent (PSE managers). By specifying targets and evaluating results ex-post, the MOU is seen by its advocates as a way to encourage governments to reduce ex-ante controls, giving managers more freedom and motivation to improve operating efficiency.

The evolution of the MOU system in India can be traced through important committee reports which have refined and fine tuned the system at regular intervals to ensure the MOU system keeps up with the evolution of

the public sector itself. The committee reports took into account the environment in which the public sector enterprises function both externally and internally and recommended changes to the system accordingly. The important committee reports with reference to the MOU system in India are:

1. Arjun Sengupta Committee Report, 1984;
2. Study on the Revamping of the MOU System, NCAER, 2004;
3. Report of the Working Group on Review of MOU Guidelines in CPSEs, GOI & DPE, 2008;
4. Report of Panel of Experts on Reforms in Central Public Sector Enterprises (CPSEs)-2011;
5. Report of the committee on the MOU system – 2012;

Arjun Sengupta Committee Report, 1984:

The beginning of the MOU system in India can be traced to the Arjun Sengupta Committee report. The committee was formed in view of failure of PSEs in meeting the expectation set forth in the Industrial Policy Resolution 1956. It looked into the issues related to organizational structures, autonomy, accountability of the management, need for technological upgradation and financial viability of loss making units among others issues. The committee made a number of recommendations. Some of the key recommendations were as follows:

- Operational autonomy to PSEs must be allowed such that PSEs do not make losses due to wrong investment decisions and due to formal or informal interference by the government in day-to-day operations of the PSEs .
- While granting operations freedom to the PSEs it is important that their investment decisions, their programmes for growth, expansion, etc. are in sync with the national priorities and mobilization and allocation of resources.
- MOU system can act as a set of conventions which would reduce the points of intervention by the Government and thus facilitate managerial autonomy. At the same time, it would ensure government's right to have needed information for evaluating performance of PSEs.
- MOU should incorporate performance evaluation criteria falling under four groups:
 - a. Financial Performance
 - b. Productivity and Cost Reduction
 - c. Technical Dynamism
 - d. Effectiveness of Project Implementation
- Government must control prices only in cases where it is justified by the nature of the product and not wherever product is being produced by a public enterprise.

The committee was the first to propose a system of evaluation of public sector enterprises through an MOU system.

Study on the Revamping of the MOU System, 2004:

Since the introduction of MOU system in 1987, many changes were introduced in the document due to changing business environment and government objectives. The Report by the National Council of Applied Economic Research (NCAER) in 2004 was the first major attempt at systematically reforming the MOU system. This study became the basis of major changes in the MOU system after 2004.

The following are some of the problems identified by the NCAER study:

- i) Dysfunctional relationship between the PSEs and government
- ii) General lack of clarity among management regarding the government's expectations from the PSEs;
- iii) Multiplicity of goals creating confusion among managers with regard to importance of profit objective.
- iv) Lack of proper methods of accountability and evaluation

The National Council of Applied Economic Research (NCAER) report came with following suggestions to the then existing MOU System:

- Report cautioned against interventions of institutions like CAG, CVC and COPU. Care must be taken that these institutions must not have an adverse impact on the performance of the CPSEs.
- The report suggested that the Task Force Members must be having technical expertise about the issues being faced by the industry again they must be neutral bodies .
- The report introduced nomenclature to parameters as follows:
 - a. Static Parameters: The ones that reflect "costs and benefits associated with the operations of the enterprise in a given period of time".
 - b. Dynamic Parameters: Qualitative parameters which lead to benefits in the future, when costs are incurred in the reference year.
 - c. Sector and Enterprise Specific Parameters: These include essential investments for broader goals.

- The report also assigned appropriate weights to each parameter.
- Report recommended Linkage of Performance related pay to the MOU system.

The NCAER report added dynamism to the parameters of evaluation and streamlined the MOU system to act as a tool for productivity improvement.

Report of the Working Group on Review of MOU Guidelines in CPSEs, GOI & DPE, 2008:

This committee headed by Shri Ashok Chandra, in 2008, submitted the report which was of vital importance in the context of the MOU in India. The main scope of the working group was improving the new methodology for performance evaluation adopted by the Department of Public Enterprises in 2004-05.

Some of important aspects looked at by the committee are:

- Determination of Base Targets and difference between different grades on the 5 point scale;
- Review the balance score card approach of giving equal weights to financial and non-financial parameters;
- Review of the syndicates of task force under the MOU system

The Working Group offered suggestions on a few aspects of the MOU system, which are as under:

- The report devised a mechanism of setting the base target as being the “sum of the figure of the best performance year plus twice the Standard Deviation”. The report also suggested that for CPSEs functioning below 100% capacity, Base Target (BT) shall be ‘Good’ while for the ones functioning at 100% Capacity, BT shall be ‘Very Good’.
- Anticipated capacity addition must be taken into account in the calculation of Base Target.
- The Balanced Score Card approach might not be suitable for a few CPSEs.
- financial parameters should be between 30-40% for CPSEs functioning under Administered Pricing regime.
- The committee also suggested the inclusion of “milestones for physical progress in projects being implemented”.

Report of Panel of Experts on Reforms in Central Public Sector Enterprises (CPSEs), 2011:

The Planning Commission and S K Roongta Committee Report (2011) titled ‘Report of Panel of Experts on Reforms in Central Public Sector Enterprises (CPSEs)’ comprehensively examines a range of issues affecting the PSEs. Highlights of this report’s recommendations for the MOU system are:

- The MOU system must have more thrust on R & D initiatives, as well as promote better rules for Joint Ventures.
- A committee for business strategy must be formed by each PSE.
- The committee recommended scrutiny of the process of determining the Base Target,
- The committee suggested consideration around external factors which affect the performance of the PSEs.
- The committee emphasised financial parameters in the MOU system must emphasize on Returns on Capital Employed (RoCE) and Return on Asset (ROA)

Report of the Committee on the MOU System, 2012:

The report titled ‘Report of the Committee on the MOU system, 2012’ by P G Mankad made the following recommendations to strengthen the then existing system of Memorandum of Understanding:

- It reviewed the process of signing of MOU by the subsidiary companies, and suggested that DPE examine the possibility of setting up an enabling mechanism to consider and permit leaving the entire process of negotiations / evaluation of subsidiaries to the PSEs or administrative ministries
- The committee opined that even though there are views around exclusion of the MOU system for certain PSEs, “it should best be left at the discretion of the Government of India, since the MOU exercise has always been meant for the Public Sector Enterprises irrespective of their size, sector or activity.”
- The committee decided against exclusion of sick and loss-making units out of the MOU system.
- The committee advised to retain the 50%-50% balance between financial and non-financial parameters.
- Inclusion of negative marking for non-compliance was recommended.
- Provisions to address situations where targets remain unachieved due to external forces were also suggested in the report.
- The committee recommended that the Non-Financial parameters should also include Corporate Social Responsibility, Sustainable Development, Technology, R& D, Quality, Innovation, Human Resource Management etc.

The above committee reports and recommendations have been key to gradual evolution of the MOU system in

India. A brief description of salient features of MOU Guidelines applicable for the Year 2017-18 and onwards is as follows:

“There would be uniform parameters for (a) measuring financial performances such as revenue from operations, operating profit and return on investment (e.g. ratio of PAT/Net-worth). This would be applicable to all CPSEs, except CPSEs which are dependent on government grant or performing functions of distribution of grant etc. e.g. Biotechnology Industry Research Assistance Council (BIRAC). Hence, 3 financial parameters have been prescribed for all CPSEs with total weightage of 50% except for CPSEs like BIRAC.

For the remaining 50% weightage, a menu (b) of parameters has been suggested for selection depending on the sector in which the CPSE is operating. Separate format has been given for Finance Sector and another format for the remaining operating CPSEs . The parameters most appropriate and relevant for measuring performance shall be suggested by the Pre-Negotiation Committee (PNC).

For CPSEs under closure/under construction/(c) under reconstruction, parameters have not been prescribed leaving it to the PNC to suggest the most appropriate parameters and targets for IMC to take decisions. For such CPSEs, the emphasis should be to suggest parameters and fix targets for starting commercial operations as early as possible. For CPSEs under closure, the targets would be for ensuring time bound closure.”

Mandatory Parameters (50% weightage) (Applicable to all CPSEs distributing Government Grants)

Financial Performance Criteria:

- Turnover (Revenue from Operations)
- Operating Profit/Loss
- Return on Investment

Other Parameters (50% weightage)

Performance Criteria (Applicable to all operating CPSEs except CPSEs in Finance Sector)

- Capacity Utilization
- New Orders
- Exports R&D
- Increase in Market Share
- CAPEX
- Revival Measures
- Various Efficiency Ratios etc.

There are sets of other parameters applicable to CPSEs operating in Finance Sector and CPSEs under closure, under construction /re-construction. Weight for the set of parameters applicable to CPSEs under closure / under construction is in excess of those of financial parameters.

MOU Evaluation:

Evaluation of MOU of the CPSE is done after the end of the year on the basis of actual achievements vis-à-vis the MOU targets.

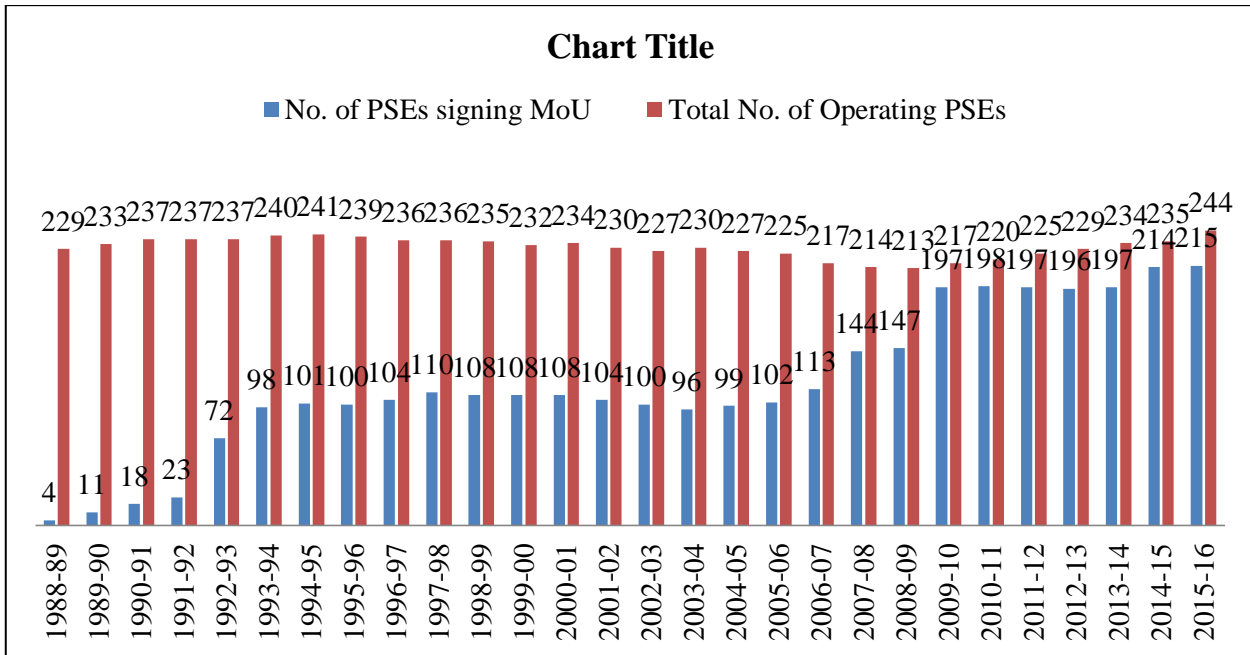
Grading of PSEs:

The performance of the enterprises in the MOU system is scored on a 5 point index which is calculated as the aggregate of all the "actual achievements" as against the targets set in the 5 point scale. The rating is done based on the MOU 'Composite Score'.

MOU Composite Score & Rating

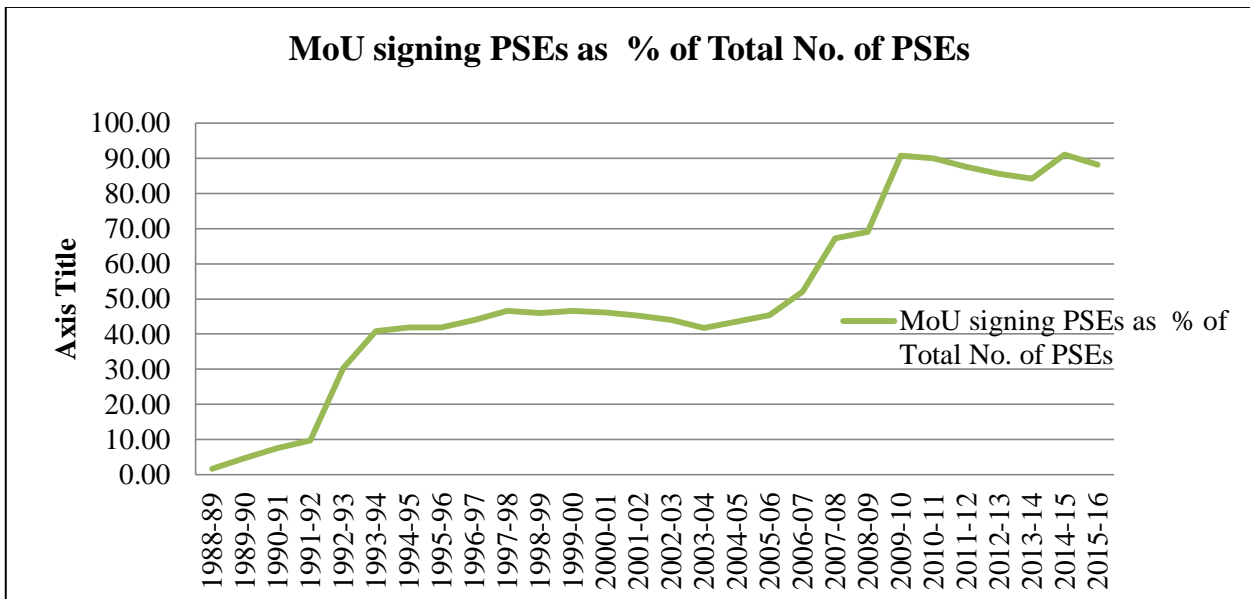
MOU Composite Score	Rating
87.5 to 100	Excellent
Less than 87.5 - 67.5	Very Good
Less than 67.5 -37.5	Good
Less than 37.5 -12.5	Fair
Less than 12.5	Poor

**Implementation of MOU and performance trajectory of Public Sector Enterprises:
 Figure 1**



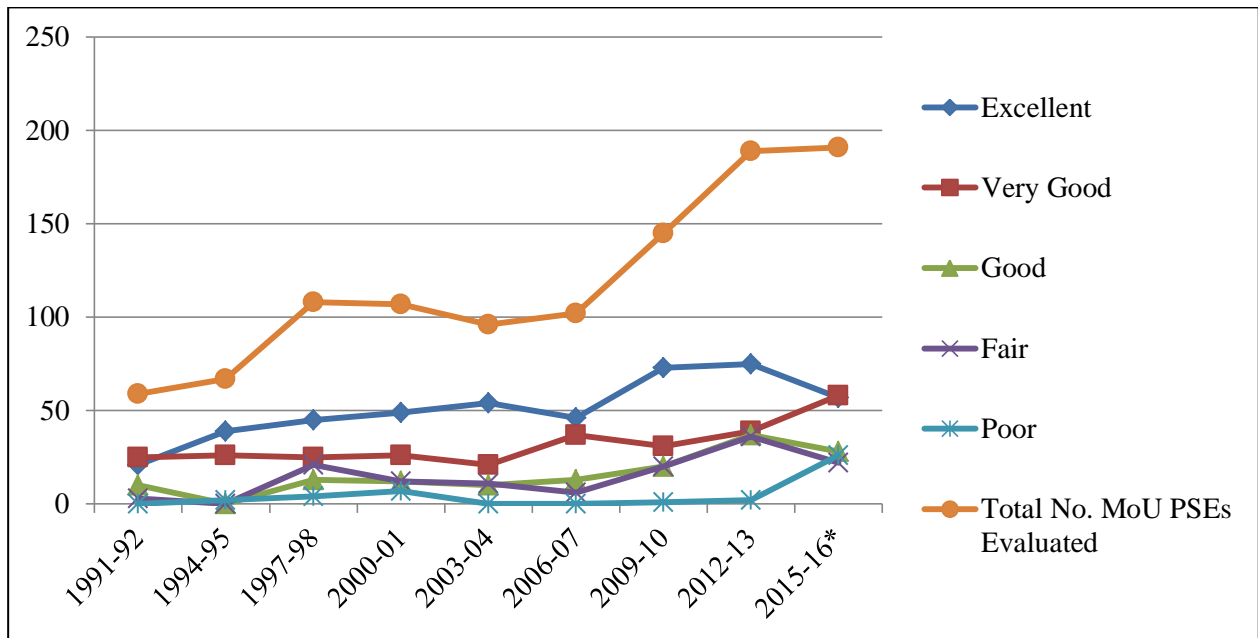
During the Financial Year 1988-89 (FY 88-89) , for the first time , four PSEs joined the MOU system. This number grew rapidly till FY 93-94. From that year till FY 05-06, for more than ten years, number of PSEs under MOU system remained almost stagnant. The real expansion in the scope of MOU system took place after FY 06-07. By the FY 2015-16 out of 244 operating PSEs, 215 were within the scope of MOU system (Figure 1). Hence , over a period of two and half decades almost the entire universe of the PSEs has come under the MOU system.

Figure 2



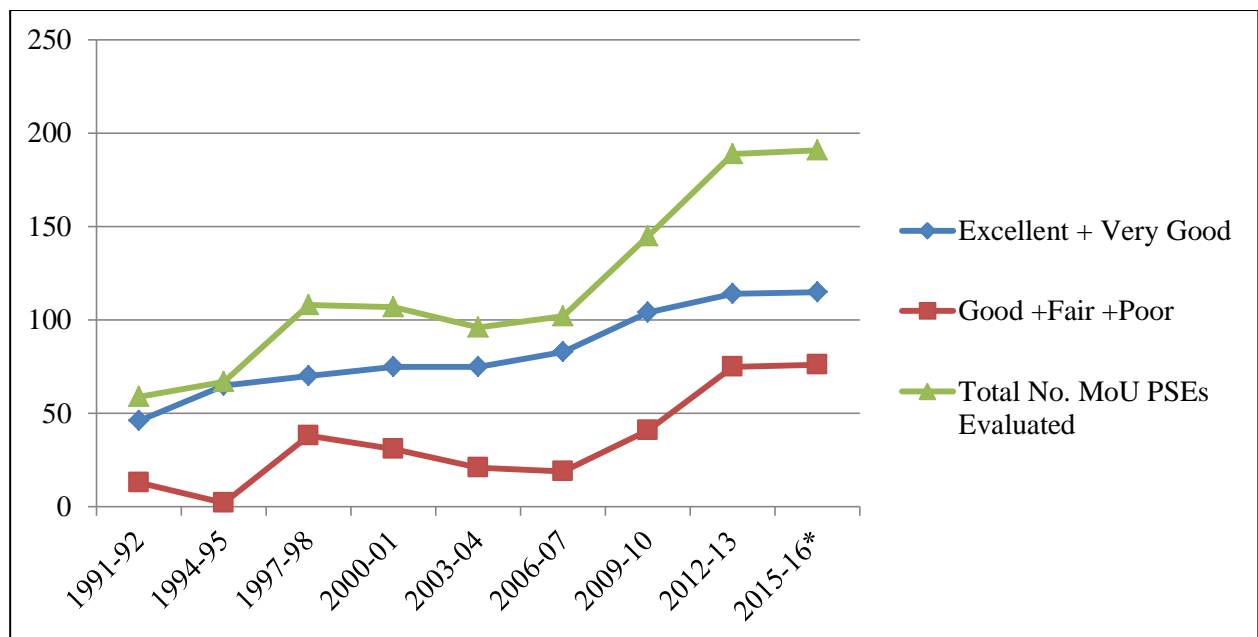
MOU received acceptance both from the management of the PSEs and the respective ministries after its introduction . Figure 2 depicts MOU signing PSEs as a percentage of the total number of operating PSEs. The graph shows the expansion of the coverage of MOU system. In percentage terms, approximately 90% of PSEs are under MOU system in FY 2014-15 as compared to less than 2% in FY 1988-89 when this system of performance appraisal was adopted by the government.

Figure 3



Targets under MOU are given before the commencement of the financial year and evaluation of the performance and assignment of rating takes place after the end of the financial year on submission of the performance data. Rating is assigned on the basis of achievement of targets. Figure 3 shows the trend of total number of MOU PSEs evaluated and their performance rating. The number of PSEs with 'excellent' and 'very good' ratings has always been more than those with 'good' 'fair' and 'poor'.

Figure 4



For the sake of drawing meaningful inferences, it will be more useful if we combine the number of PSEs into two groups, one consisting of 'excellent' and 'very good' ratings and other consisting of 'good', 'fair' and 'poor'. Figure 4 has been traced with data combined in this manner. The trend line showing the number of PSEs with 'excellent' and 'very good' ratings rises smoothly despite the fluctuations in the total number of PSEs under MOU. It reflects gradual rise in the performance of the PSEs coming under the system of MOU.

Figure 5

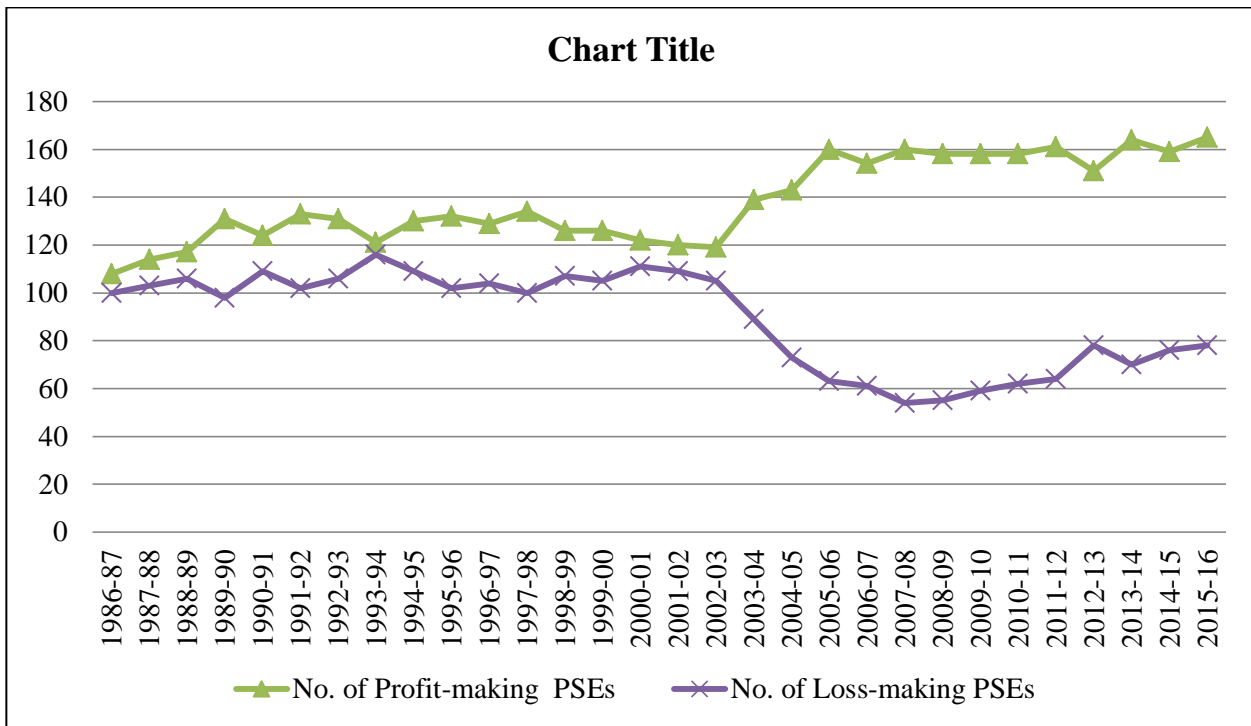
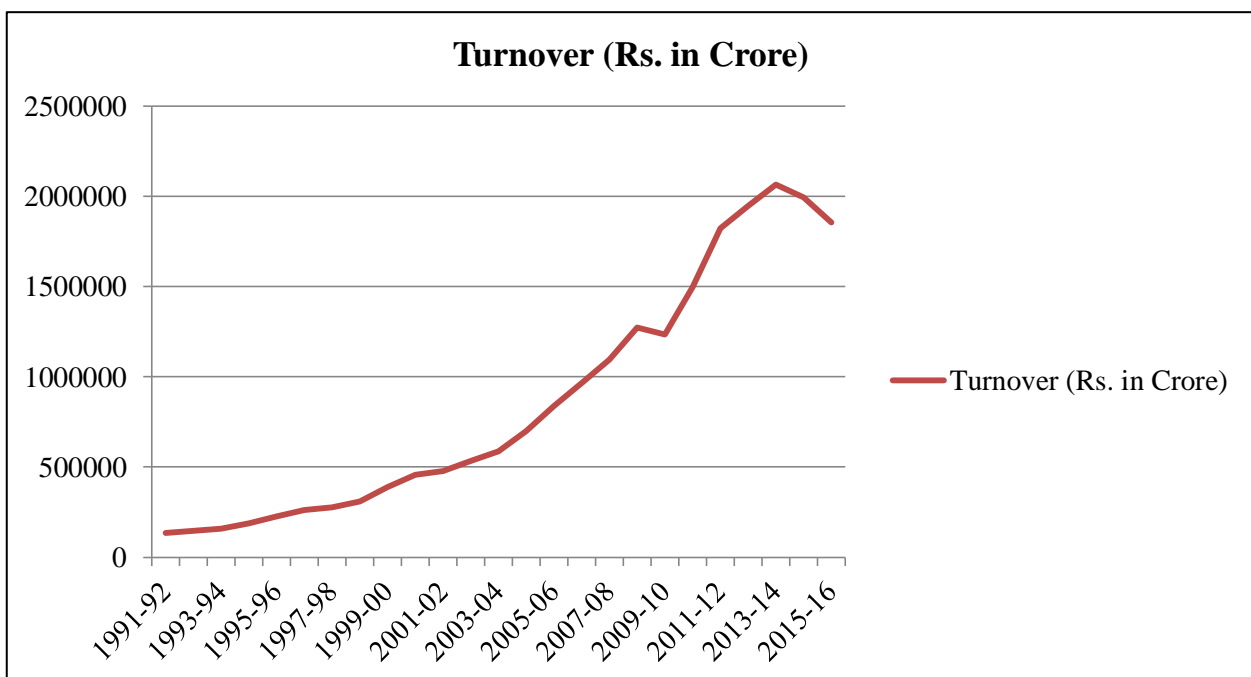


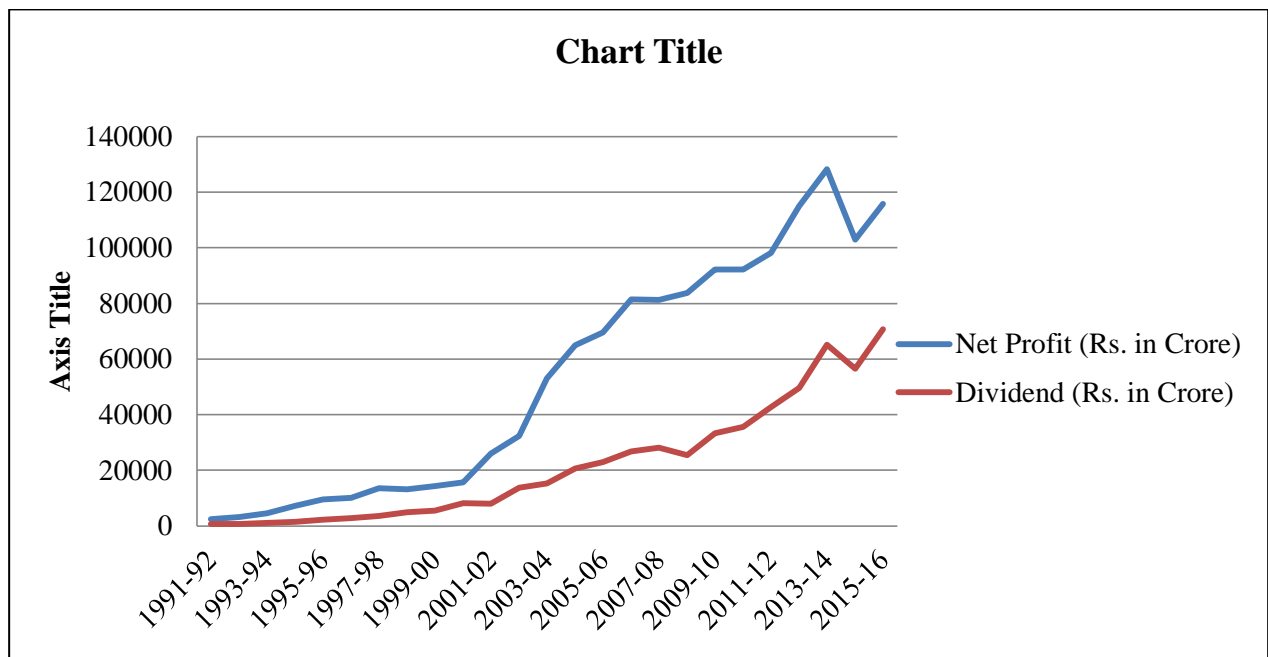
Figure 5 shows the trajectory of ‘number of profit-making PSEs’ and ‘number of loss-making’ PSEs. We can draw an interesting inference here: as the number MOU PSEs rises, the number of profit-making PSEs rises sharply and the number of loss-making PSEs declines sharply.

Figure 6



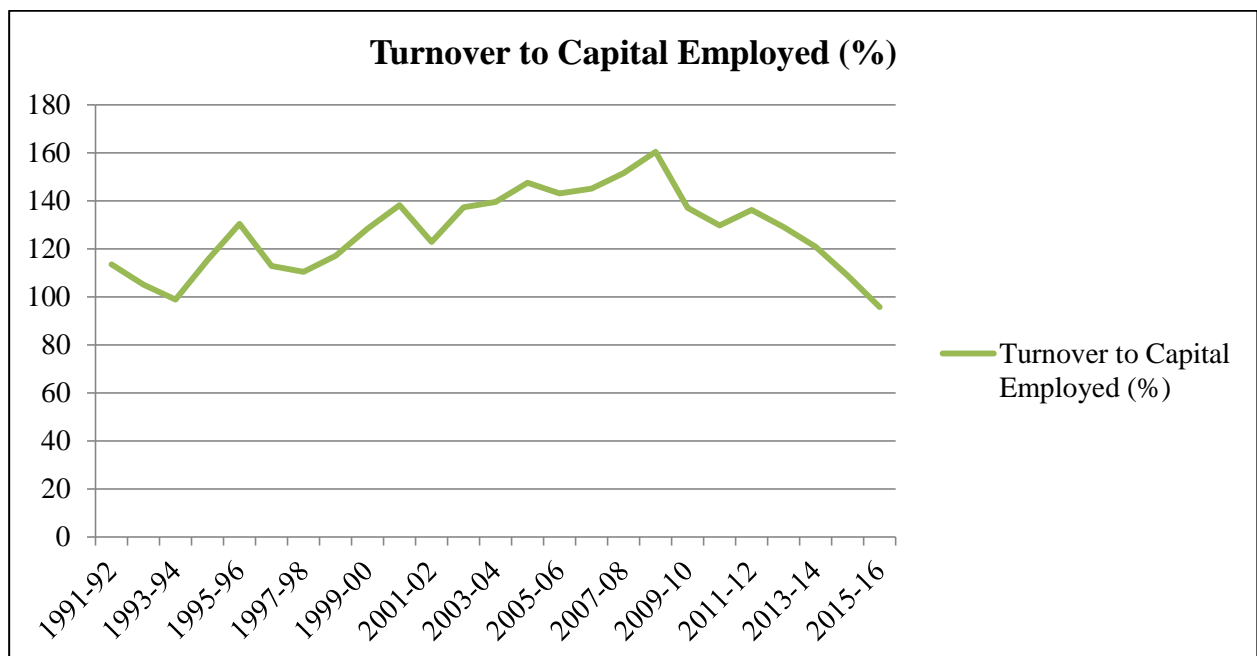
Sales turnover of PSEs as a whole has shown impressive growth over this period. However, there is a decline after peaking in FY 2013-14.

Figure 7



Both Net Profit and Dividend have also shown impressive growth over the period under study. As is clear from Figure 7, PSEs have been able to generate sizeable funds through retention of profits. Despite the decline in turnover after 2013-14, profit growth has been positive after a dip.

Figure 8



‘Turnover to Capital Employed Ratio’ reflects the efficiency in utilizing the assets of the operating unit. In figure 8, we have traced the Turnover of Capital Employed in percentage over a period of twenty five years since 1991-92. Since 1919-92, after an initial deterioration this ratio showed improvement till 2008-09 when it peaked at 160.50 percent. However, since then as indicated by this ratio, PSEs are showing continuous weakening of efficiency in utilising the capital employed. In the FY 2015-16 this came down to 95.66 percent, even lower than what it was at the start of reform measures. This trend opens the scope for further study and deeper analysis.

CONCLUSIONS AND RECOMMENDATIONS:

The above study can be briefly summarised as follows.

- In view of the inefficiency and inability to generate surplus, PSEs were subjected to a number of reform measures in the late eighties and early nineties – MOU was one of them.
- Since its inception the MOU system has seen gradual expansion in its scope. Among the PSEs that signed MOU, year on year, majority of them were graded as ‘excellent’ and ‘very good’ performer.
- The number of ‘excellent’ and ‘very good’ rated PSEs rose along with the rise in the total number of PSEs under MOU system.
- There is an increase in number of profit making PSEs and a decline in number of loss-making PSEs also over the period of study.
- The overall performance of the PSEs, in terms of Turnover, Net Profit, Dividend Distribution and Retained Earnings also improved along with the rise in the MOU PSEs.
- PSEs as a whole contributed a gradually increasing amount of dividend distribution to the exchequer along with larger amount of internal fund generation for further investment in the public sector, as originally envisaged by the policymakers of independent India.
- Hence, the macro-level trend reveals that there is a broad co-movement between the performance of the PSEs as a whole and number of PSEs under the MOU system. The study recommends further strengthening of the MOU system as one of the reform measures.
- However, efficiency indicator as measured by the ‘Turnover to Capital Employed Percentage’ has been on the decline after reaching a peak of approximately 160 percent in 2008-09. The value of this ratio is less in 2015-16 than what it was at the commencement of reform measures in early nineties. In view of the declining efficiency indicator, there is need for deeper and disaggregated analysis of the public sector enterprises to identify the precise reasons for underperformance, before initiating suitable measures.

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