CHAPTER-3

PERFORMANCE EVALUATION AND RATIONALE OF PROFITABILITY.

3.1 THE PROBLEM.

The performance of public sector over the years has come under sharp criticism primarily on account of the deteriorating financial position and profitability of public enterprises. There is no doubt that the performance of the public sector enterprises, in terms of profitability, has not been upto the mark. But, it is surprising that even after three decades of planning and enormous investment in public sector, an objective and widely accepted criterion for evaluating its performance has not been evolved. The criterion of commercial profitability continues to be debated and widely criticised. The performance measurement of PE has been discussed since late fifties at all levels i.e. Policy formulators, public sector executives, private sector, researchers, intellectuals, Parliamentarians, public and the press. There are two schoolsof thought. One professing profit - The return on investment as the yard stick of evaluating the performance of public enterprises, and the other group not advocating the functional concept of return on investment because of multiplicity of national socio-economic objectives such as establishment of capital intensive industry, Regional development, opening opportunities of employment, Technology absorption etc. Import substitution, self reliance, making available the products and services at cheaper rates etc.[1]

Unlike private enterprises where the volume of profits earned is generally considered a reliable test of efficiency, the performance evaluation in public enterprises is relatively a much more difficult proposition.

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1. Rahim A.M.A. "Better Management of Nationalised Industries" - Search for performance measurement Pg. 262.

While enterprises in the private sector have primarily commercial or profit objectives, PES have been set up for a whole host of considerations social, political, economic as well as commercial objectives. In spite of this striking inter-sectoral objective differentiation, most of the PES incorporated under the Companies Act, do not spell out the criteria and then educate Government and public to evaluate achievements on these criterion. As a result, unworkable profit based approach and the related accounting and reporting practice continue and uncomparables are compared.[1] True most public enterprises are broadly expected to work as commercial ventures and to earn a return on investment and this has to be consistent with their social obligations, which might work at cross purposes with the objective of an adequate return on the investment.[2]

The profitability of public enterprises is a subject that has attracted a good deal of attention. The relatively low level of return from the massive investments in public enterprises has caused concern, and has become the subject of comment by the Press, students of public administration and management, and the general public. There are two kinds of commonly prevalent attitudes: one is to deplore the performance of the public sector, make unfavourable comparisons with the private sector and exhort the public sector Management to do better; the other is to defend the public sector and to argue that financial profitability is not an adequate yardstick or indeed even the primary objective, that the public sector has to carry a heavy burden of social over-heads and has to fulfil multiple objectives, and so on. While there are elements of truth in both views, neither seems to us wholly correct.[3]

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1. Dr. Rakesh Chandra Sharma - Financial reporting in Public enterprises March '83. Pg. 53.
2. Narayanan Laxmi - Efficiency Audit - Public Enterprises in India - Orient Longman No. 1972 Pg.334
3. EARC-II Report No. 7.

National objectives (page-2) as embodied in plan frames and industrial policy resolution, can broadly be classified social, economic and financial objectives;

1. Social objectives:
a) To create greater and better employment opportunities.
b) To promote balanced regional development.
c) To reduce inequalities in income.
d) To assist development of small scale and ancillary industries.
e) To control prices of specific economic goods.

2. Economic objectives are:
a) To achieve a sizeable increase in National income.
b) To help the rapid economic growth and industralisation with special reference to development of basic and heavy industries.
c) To develop infrastructure.
d) To ensure National Control of key Industries.
e) To build up indigenous industrial technologies.
f) To earn and save foreign exchange and to promote self reliance.

3. Financial objectives:
a) To earn return on investment and generate surplus for development.
4. Physical objective:
a) To optimise production.

Multiplicity of objectives is often talked about when performance appraisal of PE is resorted. Let us look at these objectives vis-a-vis performance criterion.

3.2 OBJECTIVES AND PERFORMANCE CRITERION.

"A performance criterion is simply a quantifiable expression of the objectives of the enterprise. Since public enterprise objectives are multiple, does it necessarily follow that multiple criteria are necessary? The answer is no. Multiple objectives can be routinely handled by aggregation if they are individually quantifiable. The problem with constructing a performance criterion for public enterprise is not that its objectives are multiple, but that some of the objectives are difficult or impossible to quantity, and that agreement cannot be reached on the trade-offs (relative weights or prices) to be used in aggregation."[1] In dealing with these problems, it is useful to think in terms of two sets of objectives: commercial and non-commercial. Commercial objectives are similar to those of private firms and reflected in commercial accounting procedures. Non-commercial objectives concern external effects of enterprise operations (social and economic benefits like, the benefits of opening up a backward area, or the costs of pollution etc.) which are not reflected in private accounting procedures. Non-commercial objectives are particularly troublesome because they are typically difficult to quantify (e.g. the benefits of opening up backward areas) and/or difficult to put weights on (the degree of pollution can be measured in terms of composition, but how can this be converted to rupees?)

Fortunately, for purposes of performance evaluation, the problem of non-commercial objectives can be substantially reduced by recognizing that many non-commercial objectives are existential rather than operational. That is, they are achieved by the very

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1 L.P. Jones Towards a Performance evaluation methodology for PE - Boston University 1983.

existence of the enterprise and do not alter operational goals. They affect investment decisions but not performane evaluation criteria. Once the plant has been built, the non-commercial objective has been achieved (as Fertilizer Plant is set up and Fertiliser is produced) and the operational objectives are only commercial - to produce as much Fertilizer as possible at minimum cost. Similarly, a plant may be located in a backward region to achieve the non-commercial objective of regional equity, but once it is built, this objective has been achieved and strictly commercial considerations dominate.

In both of the foregoing cases, of course, the commercial success of the enterprises will presumably be less than for enterprises built without reference to non-commercial objectives. This is equivalent to saying that it will be expected to earn a lower rate of return. Nonetheless, the operational goal is to maximize that rate of return (or minimise the loss). The level of profit which represents "good" performance will be lower but profit remains the criterion. This raises the important methodological distinction between the general performance criterion and a particular criterion value. The first step in performance evaluation is to select a criterion (in our case profitability) which allows firms to be ranked on a continuum. The second problem is to select a criterion value (in our case twelve percent*) which differentiates "good" from "bad" performance.

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* This has been suggested at a minimum of 12% in fourth plan documents.

Operationally, in terms of a standard profit and loss statement "public profit" is:

Sales
- Inventory changes
- Manufacturing costs
- Administrative and selling costs
- Total employee costs
- Depreciation and ammortization allowances
- Opportunity cost of working capital.

3.3 PHYSICAL NORMS.

Another view that has come to front is that even though an enterprise may be making profit, it may not perform well and profits may not be optimum or profits may be due to Pricing Policy and monopolistic nature of item produced. This argument is further extended to consider physical norms for evaluation of performance of Public Enterprises. The suggested norms are capacity utilisation, inventory status, utility consumptions, industrial relations, breakdowns analysis. Achievements of physical norms would also automatically contribute to productivity, reduction in costs and higher profitability.

3.4 NEED OF PROFITS.

There is general economic doctrine that 'Unless you have money, you cannot do good'. Similar is true for public welfare and public enterprises. Unless public enterprises perform well and generate surpluses they cannot do social and economic good for the Nation. The present generation is surviving because of the capital made available by thepast generation. Future generation will survive only when capital investment grows up with the profit and surpluses generated by the present generation.

If an enterprise fails in formation - it will fail in most viable function. Besides, if Government undertakings continuously operate at a loss, the capital gets completely eroded and to keep the undertaking alive, Government help in form of massive loans becomes necessary and this may lead to additional taxation.[1] Therefore, in the context of socio-economic environment in a developing economy, the most important social objective is generation of profit itself by operating the enterprise at optimum productivity under given set of parameters.

While discussing social aspect of the pricing policy for public enterprises, EARC on Government and public enterprises in their report No. 7 have stipulated "the producing agency should be paid an appropriate price which could cover the cost of production and provide a reasonable return on investment, subject to the application of certain efficiency norms. Depressing the price and then extending a subsidy or debt relief or non plan budget support does not make much sense".[2]

3.5 VALIDITY OF THE RATIONALE OF PROFITABILITY.

It is now accepted that profitability is not a capitalistic evil, but is in fact a very important social objective in itself. EARC on Government and public enterprises in their report No. 7 submitted in 1985 also mentioned:
"We believe that financial profitability is (Except in few cases) both relevant and important and ought to be (and could be) the primary yard stick of performance evaluation provided certain distorting features are eliminated or moderated and that while there could be multiplicity of objectives and obligations cast on public enterprises, there are

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1. Prices, Profits and Pattern of Investment in PES. centre forPublic Sector Studies 1984.

2. National Convention on Public Enterprises 1976 SCOPE & BPE.

best discharged out of generated surpluses rather than incurring losses and making a draft on the Exchequer, though we do envisage direct governmental compensation offer for specific non-commercial obligations cast on public enterprises."[1]

The centre for public sector studies held a Seminar in 1984 on prices, profits and pattern of investment in public enterprises. Important illuminaries in Government, Public Sector, and Economists participated in the Seminar and expressed their views on policy, pricing and performance, the consensus was for profit and profitability concept for performance evaluation of the public enterprise. Views expressed by some of the leading personalities are:[2]

I Prof. Y.S. Mahajan M.P.:
"Public sector should generate surplus"

II Pranab Mukherjee Ex-Union Finance Minister:
"Prices should be realistic and investment should give reasonable rate of return"

III Mr. C. Venkataraman Ex-Director General, BPE:
"Prices in public sector should yield adequate return"

IV Shri L.K. Jha Ex-Chairman EARC:
" A multiplicity of goals create confusion. The public sector Management should have clear sense of direction with target of performance linked primarily to profitability"

V Shri Mohd. Fazal-Member Planning Commission:
" Public sector should generate reasonable surplus at satisfactory levels of capacity utilisation"

VI Shri I.G. Patel Former Governor of RBI, Director IIM-Ahmedabad.
" Public enterprises should make profit at internationally competitive prices"

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1. EARC-II Report No.7.
2. Prices, Profits and Investment in Public Enterprises the centre for public sector studies - 1984.