

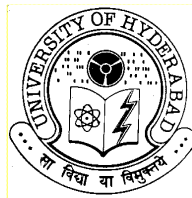
**Organizations and their Restructuring: Studies in the Indian
Corporate Sector**

A Thesis

Submitted during 2014 to the University of Hyderabad in partial
fulfillment of the award of a Ph.D degree in Sociology

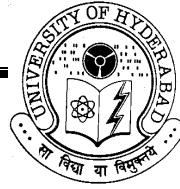
by

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CERTIFICATE

This is to certify that the thesis entitled “Organizations and their Restructuring: Studies in the Indian Corporate Sector” submitted by Chandrani Chattopadhyay bearing Regd.No 08SSPH03 in partial fulfillment of the requirements for the award of Doctor of Philosophy in (Sociology) is a bonafied work carried out by her under my supervision and guidance which is a plagiarism free thesis.

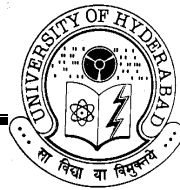
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I Chandrani Chattopadhyay hereby declare that this thesis entitled “Organizations and their Restructuring: Studies in the Indian Corporate Sector” submitted by me under the guidance and supervision of Dr. V.Janardhan is a bonafied research work which is also free from plagiarism. I also declare that it has not been submitted previously in part or in full to this University or Institution for the award of any degree or diploma. I hereby agree that my thesis can be deposited in Shodganga/INFLIBNET.

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ACKNOWLEDGEMENT

*I take immense pleasure in expressing my deep sense of gratitude and indebtedness to my mentor **Dr.V.Janardhan** for his inspiring guidance, constant encouragement and support throughout my tenure here. It is always a pleasure for me to be his student.*

I express my sincere thanks to all the faculty of Department of Sociology. My special thanks are to Prof.K.Laxmi Narayan, Head, Department of Sociology Dr.Rghava Reddy and Dr.R.Vijay (School of Economics) for sharing their ideas and providing me with beneficial tips on the topic.

I am thankful to Prof.E.Haribabu, Prof.Shashjee Hegde, Prof.Vinod Jairath, Prpf. Sujata Patel, Dr.G.Nagaraju, Dr.Aparna Rayaprol, Dr.Purendra Pasad , Dr.Ajailiu Niumai for introducing me to Sociology. I am also extremely thankful to all other faculty members of the Department of Sociology.

I thank all my M.A classmates for the memorable time in the campus we spent, their help and support. My special thanks are due to all my friends including Mamata, Illika, Devraj and Ganesh for their help and support.

All the research scholars of Department of Sociology have been extremely helpful and I thank them all. I thank my seniors Anupam Bhai, Dipsikha Didi and Harish Bhai. I specially thank my juniors Suchismita, Priyam, Anushayma, Niloshree, Dutta, Dilip, Mukesh, Raghavendra and Aditya for their help at various occasions without any hesitation.

I thank my caring friends Dr.Manasi Dalai and Ms.Imkum Naro for their unconditional help, affection and sharing their valuable time with me. I am very lucky to have such friends. I thank Dr. Prakash for his help in many ways.

I am also very thankful to all the non-teaching staff of the Department of Sociology for their support.

I wish to extend my sincere thanks to the University authorities for providing all the necessary facilities for this work. Finally I would like to thank UGC, New Delhi for the financial support during my tenure.

It is beyond this thesis to express my appreciation and gratitude to my beloved parents Mr. Samiran Chattopadhyay and Mrs.Nibedita Chattopadhyay for their unconditional affection, encouragement, confidence, full stream support and blessings throughout my life, which has made me successful at every stages of my carrier. I thank God for giving me such wonderful parents. I am extremely grateful to my father-in-law Mr. Mritunjoy Bar mother-in-law Mrs.Jasoda Bar for their affection, understanding, encouragement and support.

I specially thank my paternal and maternal grandparents for their support, guidance, encouragement and love they showered upon me. I am extremely thankful to my uncle brothers, sister-in-law, sister, and brother-in-law, for their affection, strength and valuable suggestions. I want to specially thank my sister Dr. Suchetana Chatterjee for her academic support in several occasions. It is my pleasure to thank my cute nephew- Sakyapravo for the wonderful and memorable time I spend with him. I would like to thank all my family members and relatives for their affection and encouragement.

Last but not least, I would like to express my heartfelt thank to my beloved friend, soul-mate and husband Mr.Kaushik Kumar Bar.

Chandrani

CHAPTER-1: INTRODUCTION

1.1 Introduction

The present exercise is a modest attempt at interdisciplinary research in the social sciences, though formally located in the department of sociology. It takes up for study an issue that forms a significant aspect of the course on *Corporate Business and Society*, taught at the Masters level in the department of sociology, University of Hyderabad.

Companies today are in the forefront of creating social wealth. Capitalism can be considered to have popular participation cutting across class, gender, caste etc. In the advanced societies particularly, capitalism has a mass base. The survival and success of the business firm depend upon its innate strength-the resources at its command, including physical resources, financial resources, skills and organization-and its adaptability to the environment.

Organization depends on their environment. Production, distribution and consumption of products depend on the environment. An organization has to develop competitive strategy to compete out the competitors. Strategies are the most important tools of any organization. Strategies not only link a business organization to its environment, but at the same time it helps to achieve its goals. Organizations try to resource from its internal and external environment. If an organization fails to connect itself to its environment the result is decay and poor performance of the firm. The strategies of firms differ from one another. Firms are influenced by internal and external factors. Internal factors generally describe factors which are within the firm and more specifically factors controlled by the management. External factors on the other hand, are mostly industrial factors upon which an individual firm does not have direct control. Literature on the influence of environment on business strategies is conflicting in nature. Some studies give importance to internal factors more than external factors while there are other studies which prefer external factors over internal. Although different studied give importance to different factors, but almost all studied agree that both internal and external factors play role in the strategy formulation process. Strategies of firms differ from company to company and

also from industry to industry. The difference in strategies gets reflected by the performance of the organization which can be measured using different methods.

The literature on business failure understands corporations to exist in relationship to their environment—such as its social, economic and legal environment—and to establish a position in which that relationship exchange adds more to the value and resources of the corporation than it subtracts. Management’s role is to deploy the resources of the corporation to achieve its objectives and maintain its strategic position.

‘Organization’, for the purpose of the present study, is a corporate business organization.

1.2 Business Environment

“Environment literally means the surrounding external objects, influences of circumstances under which someone or something exists” (Shaikh, 2010). Selznick (1948) defined the business environment “as flows of information relevant to goal setting and decision-making through managerial perceptions.” Duncan (1972) defined the business environment as “the totality of physical and social factors taken into consideration by a firm for making decisions. The environment of any organization is the aggregate of all conditions, events and influences that surround and affect it.” Business environment is an on-going process. Organizations need to restructure themselves with the changing business environment. The impact of the business environment on any organization is very deep and intense. Business environment consists of different factors broadly classified as external and internal factors. Environmental factors change from country to country; industry to industry even, it differs from one region to another.

“Business environment can be classified into two major categories: the external environment and the internal environment. The internal environment comprises physical and social factors within the boundaries of a firm; the external environment comprises correlating factors existing outside the boundaries of the firm” (Duncan, 1972). “As such, the external environment refers to phenomena not in control of the firm and is classified into remote and task environments. The remote environment is comprised of political, socio-cultural, economic, ecological, and

technological categories, while the task environment comprises customers, suppliers, competitors, and regulators” (Dill, 1958; Bourgeois, 1980; Olsen, et al 1998).

1.2.1 Internal Environment

The resources’ behavior, managerial philosophy, corporate culture, organizational behavior, ownership structure, strength and weakness, synergy and distinctive competencies constitute the internal environment. All these together determine the organizational capability which gets reflected in terms of strengths and weaknesses in different functional areas of an organization. Five areas which constitute the building blocks of internal environment are operations, personnel, marketing, finance and general management.

Operations Capability: Operations capability of a company is decided on its production capacity. Efficient use of raw material and related aspects which deal with a company’s capacity function are the cornerstone of an organization’s operations environment.

Personnel capability: Human resources of any company are a very important component. Success and failure of any company highly depend on the skill, quality, quantity and motivation of its human resources. Participation of employee in different stages of decision making, Employee Stock Option Plan etc. reflects the growing importance of human resource management. The overall organizational culture and also the level of communication in an organization influence the personnel capability of an organization. The involvement and initiatives of the employees of any organization varies from firm to firm and it also becomes strength or weakness of any firm.

Financial capability: Financial capability of a firm depends on the efficient use of its fund. Availability, usage and management of funds are important factors of a firm’s financial capability. Some of the important factors which influence the financial capability of any organization are as follows:

1. Factors related to the sources of funds like procurement of capital, working capital availability, financing pattern, capital credit availability, and relationship with lenders, banks and financial institutions.
2. Factors related to uses of funds capital investment, fixed asset acquisition, capital investment, relationship with shareholders etc.
3. Factors related to management of funds like financial accounting and budgeting management, state of financial health, cash, control system, inflation etc.

The factors described above are the most important factors of an organization's financial capability. Absence or presence of those few factors decides the strength and weakness of any business organization.

Marketing capability: Pricing, promotional and distributional strategies are the fundamental elements of a company's marketing capability. The better the sales figure of a company the better is the company's marketing capability.

General management capability: The responsibility of general management relies mostly on the executive management board of any company. General management deals with the overall development and performance of the company. The attitudes and values of the top management have direct impact on the objectives and functional aspects of the company. General management relates to the integration, coordination and direction of the functional capabilities of the organization. The role of the top management is also to lay down broad strategies of the company. Organizational structures, professional attitude of the top management are important factors which influence business decisions.

The role of the board of directors of any company is of utmost importance. Some studies have established that there is a direct relation between board quality and firm performance. The shareholding pattern could have important managerial implications. There are very large companies where the majority of the share is held by the promoters and there are large firms where the promoters' position is very vulnerable. Financial institutions had a large share holding in many Indian companies. The stand of nominees of financial institutions and the

relation between the members of top management are other important aspects of general management.

1.2.2 External Environment

This includes factors which are beyond the control of the management or the firm. This environment is not firm-specific rather it applies to every firm in the same industry. It considers the overall industry situation. External environment can be further classified as micro and macro environment.

1.2.2.1 Micro Environment

Customers: Customers are the main ingredient of any company. Without customers running a business becomes an empty gesture. Thus, it is the most important task of the company to retain its customers. Another major objective of any business organization is customer satisfaction. Without customer satisfaction, business can't grow and prosper. Targeting and acquiring new customers is the sole motivation behind every business decision of any business organization.

Competitors: A firm's competitors include all other firms those who target for the discretionary income of the consumers. Competitors influence each others business policies and strategies. For any product launch a company has to take care of other firms. Without any competition a market becomes monopolistic in nature, thus market imperfections become very prominent. Competitors also influence each others business decision.

Supplier Environment: Suppliers of raw material and components are very important strategic link of any business organization. How efficiently or inefficiently an organization handles the suppliers gets reflected in the balance sheet of any company. For the smooth functioning of a company it is important for any organization to source materials from several suppliers instead of one. Maintaining proper balance and interactions with different suppliers becomes an important aspect of any business organization. There are several factors that influence the supplier environment those are reliable sources of suppliers, energy and finances used for

production of final goods from raw materials and transportation facilities. Very often supplier environment helps in implementing different strategic decisions for the company.

Financers: The behavior, role and attitude of the financers become important when we analyze the micro environment of a firm. The strategies, risk taking mentality, non-financial help etc. affects the performance of any company.

1.2.2.2 Macro Environment

Political Environment: Political environment is closely related to the economic environment of any country. Several economic decisions are taken based on the political relations between different states and among different countries. How much control government should have on the economic affairs of any country is decided based on the prevailing political environment of that country. Not only the economic environment, but the regulatory environment also depends on the political condition of the country which has a second order influence on the business. State politics also play a major role. Inter-state rivalry or co-ordination has an impact on a company which is trying to build a national image.

Social Environment: The social environment factors consist of culture, values, customs and traditions. Culture has an impact on buying behavior, eating habits and overall consumer behavior. Marketing strategies of any company develop based on consumer behaviors. Social elements such as demographic factors such as gender and age, family, peer relationship, socialization etc. helps to set up the strategic management decisions of any company. Based on these social factors companies target consumers and positions its products. Education, customs, values, tastes and preferences- all of these factors directly or indirectly affect any business process.

Publics: In an age of information the role of media has become very important. Media, civil society, NGOs can be labeled as publics. These publics directly or indirectly influence the function of companies. Very often NGOs take up the cause of environmental pollution caused by industrial establishments. Media too has the capacity to make or break a company's image.

Economic Environment: The economic environment of a country consists of the prevailing economic structure and economic stage of the country at a given point of time. Economic indices like per capita income, investment, rate of savings etc. signals the economic stage of any country. Based on structure an economy could be socialist, capitalist or mixed. Each structure has certain characteristics which has a bearing on the business operations of a firm. Monetary policy, fiscal and industrial policies, budget plan, 5 year plans are all vital components of the economic environment. Patterns related to the areas of production and distribution of wealth depends on the economic structure of the country and has an impact on the business of an organization.

Regulatory Environment: Government by virtue of its rules and regulations, controls free functioning of markets. The control of government on the functioning of the economy varies from one county to another. Nevertheless the rules, regulations and economic activities of the government constitute the regulatory environment of any country. There is no room to deny that the constitutional framework or the economic policies of the government directly influences the operation of any business organization.

Technological Environment: Technology plays a very important role in the running of a company. Knowledge related to the use of material and machine for production of goods are the main components of the technological environment. Some very important aspects of the technological environment are the man-machine interface and the impact of technology on human beings. The state of technological development varies among different sectors of the industry. Development of information and communication technologies facilitate fast cross border spread of cultures, significantly influencing attitudes, aspirations, tastes and preferences. This has significant implication for business.

Global Environment: With the rise of global market the nature of competition among firms have transformed from local to global. Companies are always in the hunt for customers all around the world. The basis of competition is the service or the quality of their products.

Almost every business small or big indirectly or directly is affected by the forces of globalization. Among these are:

1. A globally integrated network between firms in terms of relationship, including customers, suppliers, and competitors.
2. Global interlocking of different systems of information technology and telecommunication have become critical components of the global economic competition.
3. Global financial markets are extremely well connected.
4. Due to the pressure of global competition the companies experience huge pressure to maintain high standards of their products and services.
5. Worldwide sourcing of manufacturing components, distribution channels and assembling of final products.

Apart from the above mentioned few other global factors such as WTO principles and agreements; other international conventions/ treaties/ agreements/ declaration/ protocols etc; economic and business conditions/ sentiments in other countries etc. affect a business. Similarly, there are certain developments, like a hike in the crude oil price have global impact.

WTO principles and regulations have far reaching implications for Indian business. Economic condition in other countries may affect the business. Recession has special importance in this context. International political factors can also affect business, like war or political tension or uncertainties, strained political relations between the nation and other countries.

It is worth mentioning here that the different factors of the environment do not work independently but rather affects each other in several ways. It is the combination of different factors which has an impact on the firm. For example, market as an environmental factor does not function in isolation but it is dependent on factors such as buyer motivation or the general state of the economy.

1.3 Context of the study

The context of the study dates back to 2007-2008. During that time the global business environment was impacted by the heat of recession. Investopedia defines recession as “A significant decline in activity across the economy, lasting longer than a few months. It is visible in industrial production, employment, real income and wholesale-retail trade. The technical indicator of a recession is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP).” Bijlani in her paper titled “Recession- its causes & effects” says “Technically, recession means decline in GDP or Gross Domestic Product of a country for two consecutive quarters. Now, this explains recession only as a definition to remember. When we go more deep, we need to first understand the meaning of GDP. Gross Domestic Product is the value of all final goods and services produced in an economy in a given year. These final goods are those goods which are not transformed into other goods. These goods are evaluated as per their market value. It means when the value of all final goods and services produced in a given year declines for two consecutive quarters, the state is referred to as "recession". It is visible in real GDP, real income, employment, industrial production, and wholesale-retail sales in an economy.” On the other hand Investor Words defines economic slowdown as “A period of slow economic growth, especially one that follows a period of robust growth. Unlike a recession, economic growth during a slowdown is not necessarily negative. For example, a country whose GDP has experienced 3%, 3.3% and 3.5% growth for three consecutive quarters, but then sees growth of 3.51% and 3.52% is not in a recession, but in a slowdown.” There is another difference between recession and slowdown, while the former has an impact on overall economy of a county the impact of the latter can be felt on certain sectors of the economy.

Troubled started in the real estate sector of the US as there was a huge debt default. But very soon the problem expanded to the financial sector. Thanks to Globalization within no time this financial crisis expanded to several economies turning it into global recession. In India the impact of global financial crisis was not felt in a manner of recession, but in a manner of economic slowdown. In India, unlike the developed countries the slowdown in the real estate sector affected the financial sector, which in turn, had a second-order impact on the real sector. It should be noted that India's integration with the global economy contributed noticeably to India's accelerated growth while the global economy was prospering. Hence, it was logical that

India would feel the impact of adverse development in the global economy. But the effect on India was less compared to other emerging markets.

The slowdown was affecting vulnerable workers, particularly in the construction sector. Among the most adversely affected were export-intensive sectors like gems and jewellery, ready-made garments, textiles and ancillaries. The effect of the slowdown in sectors such as banking, share-broking, retailing and air travel was between moderate to high. On the other hand the impact of slowdown on fast moving consumer goods (FMCG), pharmacy companies, telecommunication media, entertainment and insurance was mild (KPMG, 2009). The crisis hit hard on companies that went through some sort of restructuring just before the economic turmoil. Companies with high debt burden perished as banks were not in a position to extend any more financial help. At the same time, sales income also started to fall due to falling demand. The external business environment was ruthless.

It was in this context of turmoil in the external business environment, this present study made an attempt to understand particular cases which are/were trying to adapt to the rapidly changing business environment. Two companies have been studied one from the aviation sector and other from the retailing sector. Now, while studying these cases' attempts are made to understand the effect of both external and internal causes (agency initiated crisis) of failure. Here the problem is a mainly financial problem leading to closure of the company or resulting in overall organizational failure. In 2007-08 retailing and aviation were restricted in terms of investments compared to other sectors.

One Public Sector Company and one family run Private Sector Company are being studied. These two kinds of companies are chosen to highlight some unique governance problems and typical agency conflicts.

1.3.1 Role of management

As the business environment changes in response to globalization, information technology, communications and technological innovations; new relations and realities come into existence. These new relationships and realities, lead to the emergence and creation of new roles, as well as, different forms and modes of action and response. Together they give rise to, and define, a new and different competitive paradigm, i.e. new rules of conducting business, and playing in the competitive business games.

In trying to cope with today's business environment, firms face numerous unprecedented managerial challenges. They are expected to continue and simultaneously, excel at managing cost, quality, innovation, delivery, flexibility, performance and human resources. They are impelled to re-examine critically, their existing structures, functions, processes and control systems, toward redesigning them around customer needs and expectations. They are compulsively led to rethink their entire businesses, and change direction, in order to come to terms with new and emerging competitive realities. They are required to be both efficient and effective, low cost and high quality producer, and creative innovator, at the same time. They need to be able to keep pace with continuous change, on the one hand, and meet effectively its challenges, on the other. The cost of failure is decay, exit or extinction.

Several studies on corporate failure suggest that management (including directors responsible for the overall management of the corporation) is the source of most problems initiating corporate failure. As stated above the business environment consists of suppliers, customers, investors' etc. they are the prime stakeholders of any company. The way the management deal with different stakeholders of the company influence the growth or failure of any company. The role of the management is to strategically deal with the company's stakeholders and position the company accordingly. The skill and motivation of the top management determine how a company is going to adjust against its internal or external environment. Failure to anticipate crisis, rigidity and inflexibility in attitude, failure to coordinate a group, inexperience, misuse of assets, and overestimation of growth can all undermine the effective performance of management. It is the duty of the management to formulate financial, strategic and overall corporate policies. One can easily say management can make or break a company as the

success and failure of any company largely depends on the hands of the management. Thus, understanding the role of management becomes an important aspect of the present study.

1.4 Restructuring

In the 1990's when India economy was liberalized massive changes took place in the Indian economy. With the opening up of the economy to foreign money, knowledge and technology brought a new era in Indian economy. Restrictions were lifted by the government which opened doors for foreign companies making corporate restructuring extremely relevant in India. In the last few years, several India companies have merged with foreign companies. Several foreign companies have ventured into India either using franchising route or through joint ventures. A lot of dismantling and re-organization has taken place. "Corporate restructuring is the process of dismantling and reconstructing either a whole organization or certain divisions of a corporation that need special attention. This may require considerable movement of the company's liabilities and assets" (Gaughan, 2002). "The restructuring is a process of making a major change in organization structure that often involves reducing management levels and possibly changing components of the organization through divestiture and/or acquisition, as well as shrinking the size of the work force" (Martin,1998). Corporate restructuring is done for a variety of reasons. Improvement of a firm's performance is often a major cause for restructuring, but apart from that on several occasions in order to survive or avoid closure companies go for restructuring. Restructuring is a way to formulate new strategies to successfully or more efficiently run a company. It is very important to note here that although most of the times, restructuring of the company results into positive responses, but it is not uncommon for a company to experience failure because of restructuring. Restructuring of a company is a complex operation. If restructuring is not performed strategically than very often it brings the company to the verge of extinction. This is what has happened with the firms being studied in this project. Leadership and proper handling of human and non-human assets during restructuring is a very important aspect. Failure to which results in huge mismanagement of assets and that is not healthy for any firm's survival.

1.4.1 Reasons behind Organizational Restructuring

There are several reasons for a company to opt for restructuring. Some of the common reasons behind restructuring are takeovers, mergers, acquisitions or underperformance of the company. A company can decide to restructure if there is a recession or sudden liquidity crunch or a slump in the overall economy. The most common reasons for Corporate Restructuring within an Organization are discussed below.

Firstly, a company can decide to restructure if there is a slump in the economy. Due to the slowing down of the economy the company might face financial pressure. To fight against that financial pressure companies can restructure. Debt restructuring or any other kind of financial restructuring is often used as a measure against financial problems. The company can also down-size staff, combine departments or start resourcing to cut extra financial burden.

Secondly, an organization often restructures when the company expands very fast. In order to intensify its growth the company might need internal restructuring. For example the company can spin-off or develop strategic business units and create sub management within each category.

Lastly, one of the most common reasons for corporate restructuring is takeover, acquisitions or mergers. The mergers of the original company with some other company forces the original company to restructure its divisions and renew its products or services.

It is important to mention in this context, that companies studied here experienced or experiencing restructuring owing to the above stated **first and last reasons**.

1.5 Objectives of the study

During the last decade, literature on decline has grown exponentially. Beginning with projections of impending shortages and reductions in the early 1970s (Bogue, 1972; Boulding, 1975; Cheit, 1973; Hirschman, 1970), decline has become an important focus of writing in

organizational and management theory (Hirschorn, 1983; Levine, Rubin, & Wolohojian, 1981; Whetten, 1980). About 70 percent of the literature on decline has been produced since 1978 (Zammuto, 1983). Literature on failure and crisis of organizations, mostly agree to the act that failure is more or less linked to the decline of the business environment. Investigators have discussed these attributes at the individual level of analysis (Staw, Sandelands, & Dutton, 1981), the group level (Krantz, 1985), and the organizational level (Whetten, 1981). “Increases in conflict, secrecy, scapegoating, self-protective behaviors, rigidity, and turnover and decreases in morale, innovativeness, participation, and long-term planning are among the common problems associated with periods of decline.” (Whetten, 1981)

“Decline, by definition, involves restricted resources and pressures to cut back” (Hermann, 1963). Hirschman (1970), Levine (1978, 1979) and others have noted the intensification of conflict under such circumstances. In times of abundance, organizations can meet most legitimate demands for resources, but with scarcity, conflicts arising from mutually exclusive resource requirements predominate. Scarcity-induced conflict also often takes the form of increased pluralism, or the emergence of many organized and vocal interest groups (Pfeffer, 1981; Pfeffer & Salancik, 1978). Billings (1980) opines that “Low morale among organizational members grows as conflict becomes widespread and a mean mood dominates the climate” (Billings, Milburn, & Schaalman, 1980; Bozeman & Slusher, 1979). The elimination of slack resources like contingency accounts, reserves, or new project funds and of organizational redundancies is also a natural reaction to the increase in competing demands for operating funds (Boulding, 1975; Boyd, 1979). This in turn “reduces the organizational flexibility needed to cope with unfamiliar or uncertain conditions and leads to centralization of decision making, since top management is tightly controlling resources and mistakes become more visible and less affordable” (Rubin, 1977, 1979; Starbuck, Greve, & Hedberg, 1978; Starbuck & Hedburg, 1977).

When organizations fail to adapt to the changing external environment decline takes place. Decline also happens when pressure on the organization is felt from its internal environment. In order to come out of any kind of crisis, it is important for the organization to anticipate the pressure in advance so that they can take certain steps and neutralize this pressure. Companies

often fail to anticipate any external or internal pressure thus, it often fail to avoid a crisis or to implement crisis management techniques. Very often crisis within organizations take place when firms fail to utilize their opportunities. Sometimes uncontrolled expansion of organizations becomes the main reason for the firms decline. Expansions demand additional finances, if the firm fails to strategically plan its expansion programme very often the pressure of extra finance brings them on the verge of collapse. For expansion if the firms depend on an external source of finance and a credit crunch or financial breakdown takes place in the economic environment than unprecedented or in-appropriate expansion can take heavy toll on the company. This is exactly what happened with one of the company studied in the project. “The speed, depth, or severity of any decline due to inappropriate expansion will therefore depend partially on the level of support from the external environment as well as on available internal resources” (Hambrick and D'Aveni, 1988). If a company wants to avoid crisis, it is very important to recognize its early signs because if, it fails to do so the problem becomes out of control which can ultimately result in the dissolution of the company.

The main objectives of the present study are:

- The main objective was to study how managements (agency) of business organizations perceive, understand, plan and implement strategies and policies and restructure organizations in a time of organizational failure and attempt to come out of the crisis. Whether the failure is primarily due to external factors, internal factors or a combination of both.
- An examination of the crisis, which, doubtless, was done, was thus the first instance of the examination of management action; how far did the management cause the crisis in the first place? An important aspect of this examination is the concept of principal-agent relationship and how it was understood and practiced by all the stakeholders. How did management perform as regards the same aspect?
- Also, while analyzing the problem of agency an attempt was made to understand if there was a relation between the ownership structure of the company and performance of the company.
- A macro level analysis of retail and aviation industries was done to understand the challenges and opportunities of the respective industries.

An examination of the above would mean studying social action (in a Weberian sense) within the organizations concerned. It makes for a study of interactions between groups of people having similar and not-so-similar interests and imperatives, and, at times, also perhaps a conflict of interests, if not perception. The focus is on managements as the agency being in the 'cockpit'.

1.6 Methodology

I used case study method to carry out the present study. Two cases were studied. Both primary and secondary sources were being used for data collection. The In-depth interview was the main method of data collection, although in certain situations observation method is also being employed. A purposive sampling technique was used to identify respondents then snowballing technique was employed to identify further respondents. The respondents include managers at various levels and several unions. Several techniques for selecting the sample were used. While selecting the respondents special importance was given to choose people who can highlight on critical aspects of the companies. Interviews were qualitative in nature and most the questionnaire was semi-structured so that the respondents can freely talk and give their opinion. Interviews were carried out among key stakeholders of Air India and Subhiksha. During the interviews several sub topics and themes also came up. Probing technique was deployed to gather maximum information from the respondents. Interview guide was used to carry out the semi-structured interviews, so that the interviews remained focused. The sample size for Subhiksha was 38 (Senior Management 7, Middle Management 7, Employees 20, Trade Analysts and Advocate 4). The sample size for Air India was 72 (Unions 15, Senior Management 12, Middle Management 10, and Employees 35)

The data was analyzed using the content analysis technique. With the use of the interview guide coding frame was used. Then topics and utterance of the respondents were linked to the coding frame. At several points I have used quotes to explain different points. Apart from primary data secondary data was largely used for this project. Company reports, business journals and newspapers were the main sources for secondary data.

CHAPTER-2: THEORETICAL ORIENTATION

2.1 Introduction

The study is interdisciplinary in nature and draws heavily from New Institutional Economics and New Economic Sociology. The theoretical chapter can be broadly classified into three sections. The first section gives a brief account of Max Weber's ideas of Economic Sociology. It is used as an entry point to the more focused discussion on New Institutional Economics and New Economic Sociology, which constitutes the second section of the chapter. The section deals with the broad ideas and debates of New Institutional Economics and New Economic Sociology. In the third section the chapter narrows down to the agency theory and theories of corporate governance as derived from New Institutional Economics and New Economic Sociology. Agency theory and theories of corporate governance are the operational theories of the present study. The thesis tries to analyze the cases from the concept of agency and governance theories.

Section-1

2.2 'Economy and Society': Max Weber

Weber's most important writing in the field of Economic Sociology is "Economy and Society". Although all of Economy and Society can be regarded as a study in Economic Sociology certain of its parts fall more obviously in this area. Chapter two of Economy and Society called 'Sociological Categories of Economic Action' gives a theoretical account and a foundation of Weber's approach of what constitutes Economic Sociology. In the first two paragraphs of the chapter the concept of "economic action" and the concept of "utility" are being discussed. The key message in the first two paragraphs is that economic sociology, just like economic theory, analyze economic action, but unlike economic theory it takes into account that the actors orient their action to other actors. Main concepts of Weber's work which have an application in Economic Sociology are as follows. 1) Economic Action, 2) Household Vs Profit-making, 3)

Economic Rationality, (Formal and Substantive) 4) Appropriation, 5) The Market, 6) Types of Capitalism and 7) the significance of politics for the economy.

1) Economic Action- Economic action becomes an action only if the actor attaches a subjective meaning to his or her behavior. The action becomes social when it is oriented to the behaviors of others or to an order. According to Weber all economic phenomena have “a peculiar type of subjective meaning” why peculiar? The, answer according to Weber is that it is oriented to various aspects of the economic process (Weber 1907).

Weber notes that economic action does not always have to be social, but most economic actions are clearly social. Most economic actions are oriented to the behaviors of others, which makes the action social. For example, people work for someone; buy for someone and so on. Weber notes that economic action deals with scarcity and includes “power of control and disposal”. The scarcity postulate mainly deals with the means. If there were plenty of means available; one would not have to make provision to get them. There is an ongoing struggle of interest over the scarce resources. One also has to have control over one’s means so that others will not take them. The idea that economic reality is basically an on-going struggle of diverse interests between several economic actors is the focal point of Weber’s economic sociology.

According to Weber (1907) “economic action is making provisions for means to satisfy a desire for utilities.” “Making provisions for means” refers to productive activity, while “satisfying a desire for utilities” refers to consumption or profit making by a firm. Weber’s definition of the economy has the same concepts like production, distribution and exchange as perceived in modern economics.

According to Weber economic actions are special kind of actions which are motivated by material interests of the actor and actors orient their actions towards others based on the economic motive. Weber opines that “economic action” is a sub category of the broader concept, “economically oriented action.” Economically oriented action is characteristic of non-industrial societies, but economic action is typical of modern society.

According to Weber there are certain differences between Economic Sociology and Economic theory. Both “economic action” and “economically oriented action” concerns Economic Sociology while economic theory deals only with the former. Unlike economic theory Economic Sociology includes economic power in its analysis (power of control and disposal). Finally Economic Sociology, but not economic theory exclusively looks at economic action as an action which is oriented to the behaviors of other actors. This last qualification according to Weber makes Economic Sociology very unique.

2) House holding Vs profit making- According to Weber “house holding” and “profit making” are two basic types of economies. House holding refers to the primitive economy when house or family was the unit of production. Profit making refers to the modern economy where the production function of the family has shifted to firms or other economic organizations. Weber defines house holding by contrasting it to profit making. Household is oriented to consumption and the needs of its members; profit-making is oriented to opportunities to make profit. The formal definition that Weber provides in *Economy and Society* reads as follows: “The continual utilization and procurement of goods, whether through production or exchange, by an economic unit for purposes of its own consumption or to procure other goods will be called budgetary management? Profit making is activity which is oriented to opportunities for seeking new powers of control over goods on a single occasion, repeatedly or continuously.” (Weber, 1921-1922, 1978)

House holding aims at wealth and profit making at capital. This also means that the type of calculation is different. The former way of calculation is called budget and the latter capital accounting. The difference between house holding and profit making economic action has a more subjective element involved than on the action per se. According to Weber “They are in fact is the analysis only distinguishable in terms of the meaningful orientation of the corresponding economic activities. But even if house holding and profit-making constitute two very different types of organizing economic action, they do not necessarily exclude one another.” (Weber, 1921-1922, 1978)

Weber pointed out that these two economies namely house holding and profit making differs in terms of the division of labor.

3) Economic Rationality- Weber splits the concept of rationality into two: “formal” and “substantive rationality.” Weber defines formal rationality as the degree to which “quantitative calculation” is possible and actually carried out in an economic action. The existence of money facilitates this calculation. Substantive rationality is defined as follows “the degree to which the provisioning of given groups of persons with goods is shaped by economically oriented social action under some criterion of ultimate values, regardless of the nature of these ends.” (Weber 1921-22). Weber suggests that the concept of substantive rationality can be applied to different parts of the economic process. It can be applied to the outcome of the economic process; to the mentality that infuses the economic process; and to the kind of instruments that are used.

In his discussion of formal and substantive rationality Weber emphasizes very strongly the element of meaning that actors attach to their economic behavior with. Weber makes it clear that formal rationality is not just a mentality; rather it exists based on certain social conditions. Demand backed up by resources fuels formal rationality. He also points out that formal and substantive rationality; can mix in reality. This mixing happens more in advanced capitalism. According to Weber there are certain production conditions which are necessary for formal economic rationality. These conditions include freedom to enter into contracts, market freedom, complete separation between the firm and the household, free labor, rational technology and a formal rational law and administration.

4) Appropriation- Appropriation represents a closed form of social relationship to which outsiders do not have access. Weber defines it as a situation when opportunities are monopolized on a permanent basis by a closed social group. “Rights” and “property” represents forms of appropriation. Rights are defined as “appropriate opportunities” and property as “appropriated rights.” Property and rights are mainly received through inheritance or by hereditary groups. Appropriation means to exclude others from opportunities or advantages. This is a central concept in Weber’s economic sociology. It is central because it is related to the power of control and power of disposal. Once you have appropriated something, you have

power of control and disposal over it. It takes legal expression in capitalist society. Appropriation can be both economic and non economic in nature, for example, appropriate opportunities of political advantages.

Weber points out that the actors who carry out an appropriation can differ. They can, for example, be individual workers or individual owners; just they can be organizations of workers or organization of owners. The object of appropriation can also differ. Appropriation can take place in any kind of economy, be it the house holding or profit-making.

5) The market- According to Weber, the two types of interaction that make up the market are competition and exchange. Exchange is defined as “a compromise of interests on the part of the parties in the course of which goods or other advantages are passed as reciprocal compensationCompetition is any type of formally non violent social action that allows one to seize control over something that also others want” (Economy and Society). Buyers compete about who will be in a position to buy, just as sellers compete about who will be in a position to sell. The market is found in one particular area and consists of repeated acts of exchange. Weber gives importance to the price-making mechanism of markets. Power and interests play central roles in the formulation of prices. “Prices are instruments of calculation only as estimated quantification of relative chances in their struggle of interests.”(pp 108)

Weber devotes much attention to the regulation of the market. At one extreme there is the “free market” and at the other extreme, there is the market which is fully regulated- by traditions, convention or the structure of interests. The exchange that takes place in a market can only be rational, if it is not regulated. Weber, however, pointed out that economic power of certain actors can regulate a free market. This according to Weber is “substantive regulation”. Substantive regulation creates “capitalist monopolies”.

6) Types of Capitalism- According to Weber there are three basic types of capitalism: “Rational capitalism”, “political capitalism” and “traditional commercial capitalism”. Weber points out that there are seven types of orientation to profit making. Most of them, he adds had existed for thousands of years, while two are unique to the modern west. These two constitute rational

capitalism. The first of two forms, Weber specifies, consists of trading in a free market and producing goods according to the principle of capital accounting. The second form of rational profit making includes speculation in standardized commodities, securities and related forms of finance.

Political capitalism is characterized by the fact that profit making is possible by the political system rather than the market. Traditional commercial capitalism is described by Weber as small scale trade in goods and the buying and selling of currencies. Weber adds two important conditions to rational capitalism they are capital accounting and the capitalist firm. Rational capitalism requires free labor and a predictable legal and state administrative environment for proper functioning. Capital accounting is indispensable to rational profit making, according to Weber. Capital accounting is a form of calculating profit. “ Capital accounting is the valuation and verification of opportunities for profit and of the success of profit-making activity by means of a valuation of the total assets of the enterprise at the beginning of a profit-making venture, and the comparison of this with a similar valuation of the assets still present and newly acquired at the end of the process, in the case of a profit- making organization operating continuously, the same is done for an accounting period,” (Weber Economy and Society). Capital accounting is closely linked to the key actor in rational capitalism, the firm.

Weber pointed out that the firm emerged out of the household. During the middle age in Europe, the firm’s property got separated from the household. Around the same time, the firm became conceptualized as an actor in its own right. Then gradually the modern shareholding firm emerged.

According to Weber the most important economic organization in modern society is the firm. From an action viewpoint it consists of systematic and rational forms of profit making. Firms are large bureaucratic economic organizations, and are characterized by capital accounting. A rational firm is oriented to profit-making in the market, in a methodical and calculative manner (Weber Economy and Society).

7) The significance for politics for the economy- A key aspect of Weber's economic sociology is his discussion on the relationship between the economy and political bodies. Weber discusses two important connections between the economy and political bodies. They are: through the monetary system and the financing of political bodies. Weber emphasizes that the modern state has a monopoly on creating money and on regulating it through monetary policy.

Commenting on financing of political bodies, Weber says there are many ways through which political bodies can acquire economic resources. For example taxation, this is administered by the staff of the state. He was also interested in the effects that the financing of political bodies had on the economy in general. There are other factors which have influenced the development of the major forms of the economy. There is the impact of science and technology. The social forms of economic organizations, such as the firm have not appeared automatically but have had to be invented.

Weber's economic sociology develops in a very systematic fashion. It begins with economic action and continues over economic organization to economic life on a macro level.

Section-2

2.3 Basic Ideas of New Institutional Economics (NIE)

New institutional economics (NIE) is an economic perspective that tries to explain economic activity by analyzing the social and legal rules and norms that predicated economic activity. Unlike other economic theory modern institutional economics is based on neo-classical theory with certain modifications. The theory is build upon the basic determinants of institutions and the way institutions modify the choice set available to human beings; It is build on this premise so that we can not only define the choice set really available to people at any time, but also analyze the way in which institutions change and therefore alter the available choice set over time.

2.3.1 Neo-classical theory and NIE

Neo-classical economics failed to explain two questions properly. First, the role played by different economic organizations, like firms. The second question was regarding economic disparity, like why there are developed and underdeveloped economies despite multiple efforts of reform or foreign aids. New institutional economics arose as a response to Neo-classical theories and dealing with these questions became the objective of New Institutional Economics.

The standard neoclassical paradigm viewed the economic system as a mechanical system, which adjusts itself through the simple laws of demand and supply via the coordination of the price mechanism. Neoclassical economists long treated the firm as a black box, and reduced it into a production unit, which turned inputs into outputs, responding to price change and available resources so that profit can be maximized. This system worked under certain basic assumptions that were not well received by the founders of NIE, such as the premise that in a world of instrumental rationality institutions are useless because information is perfect, transactions are costless and individuals are rational wealth-maximizers with stable preferences.

The new institutional economics attempted to incorporate a theory of institutions into economics. The new institutional economics builds on, modifies, and extends the scope of neoclassical theory so that it can deal with an entire range of issues which were beyond its domain. NIE builds its theory on Neo-Classical Economics' fundamental assumption of scarcity and hence competition. This is the basis of the choice theoretic approach that underlies micro-economics. NIE abandons the concept of instrumental rationality which makes neoclassical economics an institution-free theory. The concept of "instrumental rationality" is based on the assumptions that values are constant; an individual can perceive the world in an objective manner as it really is, and the decision maker makes the decision based on rational and calculative knowledge as he possesses all the information required for making any decisions. Simon (1986) pointed out that if we accept instrumental rationality then two important consequences follow. First there won't be any necessity to distinguish between the real world and the decision maker's perception of the real world as the decision maker will always perceive the world as it really is. Second anybody can calculate and determine the choices a rational decision maker is going to make based on one's own knowledge of the real world and without the knowledge of the decision maker's perceptions, as information is complete

(provided somebody knows the decision maker's utility function). Thus a modification of the instrumental rationality assumption becomes the starting point for an institutional theory. Individuals possess limited mental models to interpret the world around them and the information gathered based on the mental models is incomplete. These mental models are derived for the individual's cultural background. Thus these models differ from culture to culture and from society to society. These mental models are exclusive for a particular environment and therefore also vary widely with different environments. Thus, there is immense variation in mental models and individual perceptions. Unlike the neo-classical assumption people differ in the way they calculate, perceive and interpret the real world, as individuals make choices on the basis of their mental models (Hahn, 1987). The incomplete information and limited mental capacity determines the cost of transacting which underlies the formation of institutions.

Neo Classical Economics' failure to answer two basic questions, as stated earlier progressively structured NIE's two leading schools. "One school of thought is identified with Ronald Harry Coase and Oliver Williamson, and analyzes property rights and contracts at the firm level; while another, identified with Douglass North, analyzes broader institutional environments and the role of the state." It is worth mentioning here that for the present study the school of thought identified by Williamson and Coase is being used or has relevance. Ideas and thoughts of North are mentioned just to make a reference. Ronald Coase, Douglass North and Oliver Williamson transformed the concept of institutions into powerful conceptual and analytical tools. These analytical tools became the platform for vigorous empirical research. New institutional economics accepts diversity in methodologies derived from several disciplines. NIE is interdisciplinary in its orientation and has borrowed heavily from other social sciences. The three founding thinkers have led the way. They all have freely adopted from other fields: most notably, Coase from law, Williamson from managerial sciences and organizational theory, and North from political science, cognitive science, and history.

Two pioneering papers from Ronald Coase, "The Nature of the Firm (1937/1988b)" and "The Problem of Social Costs" (1960/1988a), two defining books -- North and Davis on "Institutional Change and American Economic Growth" (1970) and North and Thomas on "The

Rise of the Western World” (1973), and the land mark book “Markets and Hierarchies” (1975) by Williamson has been the building blocks of NIE. The term “New Institutional Economics” was introduced by Williamson (1975,) in his book on “Markets and Hierarchies.” It became soon a catchword for the economic analysis of institutions in general. After some additions, Williamson called later his version of NIE “transaction cost economics”, or shortly TCE (Williamson 1979, 1985). Williamson’s markets and hierarchies approach deals with social actions, which makes TCE close to sociology, but unlike sociology here the concept of social actions is understood in a dyadic setup. Although there were predecessors, as there are with all schools of economics, but mainly these contributions laid the foundation of NIE.

2.3.2 Main concepts of NIE

Bounded rationality

NIE rejects Neo-classical theory’s assumption of complete information and full rationality. According to NIE complete rationality is unrealistic. In a world of uncertainty, information asymmetry and transaction cost an individual can only have ‘bounded rationality’. This concept was originated from Herbert Simon. According to Williamson (1985) it is impossible for an economic agent to collect all information and calculate, case-by case, to find out the optimal solution on the market. Individuals therefore have limited rationality. They follow certain rules to reduce uncertainty and make decisions. They become ‘rule followers’ (Vanberg, 1994). These rules do not change frequently and are rather fixed.

Transaction costs

Transaction cost is the core concept of new institutional economics. “Transaction cost” is the “cost of negotiating”, “securing and completing transactions” in a market economy. The concept of transaction cost arose as a challenge put forward by Ronald Coase against the assumption of Neo Classical Economics’ view on economy. According to Neo Classical Economics an economy is a mechanical system structured by the rules of demand and supply. The system is adjusted by the principles of price mechanism. In an economic system firms are nothing but production units. Coase (1937) in his paper “The Nature of the Firm” challenged these assumptions and refused to accept firms as just production units. Coase pointed out that “...although production could be carried out in a completely decentralized way by means of

contract between individuals, the fact that it costs something to enter into these transactions means that firms will emerge to organize what would otherwise be market transactions whenever their costs were less than the costs of carrying out the transactions through the market.” (Coase, 1988) In “the nature of the firm” (1937) Coase applied transaction cost reasoning to explain the existence of the firm in a competitive market economy. If market transactions were costless, firms would become useless. But, in fact, because of information asymmetry, incomplete contracts and uncertainty transactions become costly. Thus firms become necessary. The distinguishing characteristic of the firm is the suspension of the price mechanism. Firms are important because the transaction costs of firms are less compared to the total transactions costs of the market. Firms save on transaction costs, which make them indispensable. “In the market a would-be trader must find someone with whom to trade, determine price and quality, reach an agreement between buyer and seller, and monitor and enforce that agreement. By eliminating the need for bargains among the many owners of the factors of production, a firm can sometimes reduce these transaction costs” (Coase 1960). In later work Coase argued that transaction costs influence not just individual firms but the entire economy. “If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place and the greater production that would flow from specialization would not be realized. In this way transaction costs affect not only contractual arrangements but also what goods and services are produced” (Coase 1992).

Williamson operationalized the concept of transaction costs. He analyzed the specific factors which determine the choice between market and firm. When it is more efficient for a firm to produce or to rely on alternative arrangements such as franchising, joint ventures, strategic alliances etc.? Which mode of production will result in least transaction cost? Williamson’s arguments mainly focused on the role of uncertainty, frequency of transaction and asset specificity. North used the concept of transaction costs to analyze the economic disparity between countries. North used the concept of transaction costs to explain the state and some of its fundamental characteristics (1990). Compared to economic market political markets are more prone to inefficiency, as transaction costs are higher in political markets. The cost of measuring and enforcing agreements is also higher in political markets. “Competition”, as an enforcement mechanism is weaker in political market compared to economic markets.

Note that TCE, as described by Williamson and Coase, is concerned with the governance structure of strictly dyadic relations.

Contracts

In the standard neoclassical paradigm, contracts are agreements between parties that are (1) perfectly enforced and (2) perfectly complete. NIE opposed to those assumptions and pointed out that contracts can't be fully or perfectly complete and perfectly enforced. The concept of contract was developed along different lines by the two main branches of NIE. One school analyzed the problem of incomplete contracts from a firm specific perspective (Williamson and Coase). Another school looked into the role of states (North). Williamson stressed the issue of incomplete contracts in a paper on vertical integration. To Williamson, a contract is “an agreement between a buyer and a supplier in which the terms of exchange are defined by a triple: price, asset specificity, and safeguards” (1996). Williamson's approach to contracts became central to NIE's analysis of governance.

The ‘Northeastern’ branch looked into the concept of contract enforcement from the context of the polity (North, 1981). North highlighted the “trade off between the high cost of protecting private property using private enforcement mechanism, versus the risk of state protection of property, which might reduce private costs but invite state encroachment on rights” (North et al., 2009; and also North and Weingast, 1989; Weingast, 1993; Greif, 2005). The risk of state protection of private property led North, Weingast, and others to emphasize on other ways the state might respect private property rights, a theme that united the two branches of NIE.

Property Rights

Standard neoclassical economics assumed that what people trade are physical commodities, but Coase argued in his paper “The Federal Communications Commission” that people trade “rights.” These rights are sanctioned by the legal system and enables people to perform certain actions. (Coase 1959). The concept can be related to Weber's idea of “appropriation.” This view of property rights was further developed by Armen Alchian. Alchian (1965) defined property rights as “a set of rights to take permissible actions to use, transfer, or otherwise

exploit or enjoy property. These rights are sometimes enforced by law but more often are enforced by etiquette, social custom, and social ostracism.” These property rights are contracts. Unlike standard neoclassical economics, which assumes contracts are complete and costlessly enforceable through the judicial system, Williamson’s work on contracts implied that contracts are incomplete and property rights would be vulnerable to opportunistic behavior and private ordering is less costly than legal systems as a remedy to opportunistic behavior.

North’s approach to property rights is state-centered. North gives attention in on the role of the state in devising the underlying structure of property rights in society. In his view, formal institutions are developed by political actors to support efficient property rights.

Institutions

Institutions are “the humanly devised constraints that structure political, economic and social interactions” (North, 1990). According to Coase “modern institutional economics should study man as he is, acting within the constraints imposed by real institutions” (Coase, 1984). According to North institutions consist of formal rules like “constitutions, laws and property rights” and also informal elements such as “sanctions, taboos, customs, traditions and codes of conduct.” North was among the first to point to the informal elements of institutions, but he insisted that the “fundamental rules of the game” are provided by constitutions and Law. North (1993) explains: “It is the interaction between institutions and organizations which shapes the institutional evolution of the economy.” The dynamics of institutional change in North’s theory stem from a continuous interaction between institutions and organizations within the context of competition over scarce resources. Institutional innovation comes from states, because unlike organizations states generally do not have a free-rider problem, Entrepreneurs are the agents of change, and organizations are the players who respond to change.

The distinctiveness of NIE

By incorporating concepts like bounded rationality NIE attempts to make neoclassical economics more realistic. Neo classical economics took human action as automated and mechanical. The very concept of bounded rationality makes human action more realistic. With the introduction of ‘transaction costs’ and property rights, NIE also takes economics in a more

social direction. NIE also points out the necessity of institutional and state support for the market to work. Giving institutions importance makes NIE a more realistic, social, historical approach to economics.

The new institutionalism has given importance not only to formal rules and governance structures, but also to informal norms and social networks. Some of this discussion has reconnected economics with literatures in sociology and political science. NIE has given due importance to concepts like shared values and state intervention to understand institutional change. This has brought NIE much closer to sociology. The distinctness of NIE as an economic school come from its most important idea that institutions matter a great deal, and that economists need to analyze the ways in which institutions shape economic behavior and outcomes, and are themselves shaped by economic, political, and ideological factors.

2.4 Basic Ideas of New Economic Sociology (NES)

With the development of NIE, economics got connected with other social science disciplines. As a further development of this alliance sociologists developed “New Economic Sociology” (NES). Students of Harrison White like Robert Eccles (1981), Mark Granovetter (1985) and Michael Schwartz started NES at Harvard in the 1980s. Independently of the Harvard group, several other sociologists joined NES, among them are Mitchel Abolafia (1984), Susan Shapiro (1984) and Viviana Zelizer (1983). Their objective was to attack economists “by elaborating the sociological viewpoint as forcefully as possible.” (Granovetter and Swedberg 1992).

According to Smelser and Swedberg (1994) NES is influenced by the theoretical orientation of both Weber and Parsons. However, the concept of “embeddedness” as used by Granovetter in the sense that “economic action takes place within the networks of social relations that make up the social structure” is the central and common theme of NES. DiMaggio (1990) adds that “economic action is embedded not only in social structure but also in culture.” NES deals with several themes like “the sociology of markets” (Barber 1977, Adler and Adler 1984, Mintz and Schwartz 1985, Burt 1982), “the sociology of the firm and industrial organization” (Useem

1996); “the critique of transaction cost economics” (Granovetter 1985, Fligstein 1985, Perrow 1981), “the sociology of industrial regions” (Saxenian 1994) etc.

Sociological concepts are targeted on social action, “which ... maybe oriented to past, present or future behavior of others” (Weber, 1968). Interestingly, the reference point is, for Weber, the same as for neoclassical economists – the ideal type of a “purely rational course of action ... which has the merit of clear understandability and lack of ambiguity. By comparison with this it is possible to understand the ways in which actual action is influenced by irrational factors ...” (Weber, 1968). Weber used as reference point “the zero transaction cost” world with perfect individual rationality, which was opposed by the representatives of NIE. Demsetz (1968) coined the term “nirvana approach” for such comparisons.

2.4.1 Some fundamental Sociological concepts of NES

(1) Economic Action as Social Action:

“Economic action is seen only as a special, if important, category of social action”(Granovetter 1992). Economic action is always structured by social concepts like equality, power, hierarchy, trust etc.

(2) Embeddedness of Social Action

Economic actions are constrained by ongoing social relations and cannot be explained by reference to individual motives alone. (Granovetter 1992) They are “embedded” in ongoing networks of personal relationships, rather than being carried out by atomized actors.

(3) The Social Construction of Economic Institutions

Real world institutions do not come out of pure coordination in which agents interests coincide perfectly, they are seldom the work of an “invisible hand”. Rather they are mixtures of conflict and coordination, of opposing and coinciding interests. (Lewis 1969) Sociologists therefore understand institution to be “social constructions” and a product of visible hands. Institutions develop by trial and error and do not develop based on pure rational choice. In other words the

development of institutions can be termed as a form of boundedly rational action (Berger and Luckman 1966).

2.4.2 Sociologists' attack on Transaction Cost Economics (TCE)

New Economic Sociology mostly criticizes Williamson's assumptions of Transaction Cost Economics. They say, not transaction costs are much of an issue when we look into organizations but power, trust, embeddedness, social relationship, networks or other sociological concepts. What seems to remain a problem for economic sociologists is the rational choice tendency of TCE to analyse organizations. Sociologists criticize that "economists attribute human interaction to individual rationality and are abstracting away from fundamental aspects of social relationships that characterize economic as well as other actions" (Granovetter 2001 as opposed to Williamson 1996). Social phenomena like fairness, trust or power are reduced by economists to individual rationality. Swedberg (1994) remarked, "Quite a bit in business may be due to sociality, friendship and the like, which can be expressed in terms of [transaction] costs - but which the participants would not do so themselves."

2.4.3 Embeddedness

The concept of "embeddedness" holds together the otherwise diverse field of Economic Sociology. The concept was developed by Granovetter and it became the most important concept of Economic Sociology. The concept was developed as a critique of economic theory and its insistence that human be treated as atomized individuals. Sociologists' emphasize that economic action is a part of ongoing social relations. Thus, it is embedded in a network of several social relations. So, in order to understand an economic action it is important to understand it from an embedded perspective. Embeddedness can take many forms. Zukin and DiMaggio(1990) have suggested different forms of embeddedness like structural, cultural, and political.

Structural Embeddedness

Individuals are embedded in their social structures. These social structures both enable and constrain human action. “Structure” is patterned relations that can take several forms. “Micro” structure is networks. Networks develop through interpersonal interactions. Through our interactions people get to know other people. This “network” structures information and human actions. Networks can create trust (when personal interactions become reasonably capable of predicting each other’s behavior). Networks can also create opportunity and advantage.

Networks and social capital (the way people generally interact) can be classified as “vertical” and “horizontal”. If, a social interaction is linked through relations of authority it is “vertical”. When interactions take place among equal people it is characterized as “horizontal”. An organization is structured by both vertical and horizontal networks.

Another form of structural embeddedness comes from class structure. In democracies, political elites require resources, thus it needs cooperation from corporations and economic elites. Politicians must be careful about the policies and secure these alliances with capitalist elites. A state must carefully lay out demands which it makes (regulations, high taxes) on corporations and economic elites. If, those demands of the state become very high then it is possible that corporations may take their business to other countries. The relative power of states, on the one hand, and economic elites and corporations, on the other, and the latter’s capacity to go elsewhere, have shaped the general way different economies operate.

Cultural embeddedness

Our thinking is not “objective”, and the information we hold is not objective either. People try to see and interpret the world based on social categories. These social categories are derived from the culture. Because of cultural difference individual interpretation differs. People filter information from the surrounding social world through categories. These categories help to make sense of all the raw data an individual comes across everyday. These social categories are the building blocks of cultural embeddedness. Categories, assumptions and rituals build contexts of our social lives shape our decisions and actions. Economic theory ignores culture. Economists tend to believe that the whole world thinks in the same way and that only hard

economic rationality is important. But culture is a powerful force in economic behavior and organization.

Political embeddedness

Economies are not immune to politics. Market capitalism which dominates global economy is the outcome of political struggle. Economic actions are embedded in political networks. Thus, economic actions are influenced by political decisions. For example political leaders have changed the way labor was organized in the economy by legislating welfare and legalizing unions.

Embeddedness does not mean we are programmed to particular action. Culture, politics and structure both constrain and enable economic actions. They make certain economic actions more difficult, but may make others easier.

NIE and NES both differ in the way institution functions and how actors and organizations are influenced, but both theories accept the centrality of organizations and the importance of firm as an important type of organization.

Section- 3

2.5 Theory of the Firm

Ronald Coase (1937) in his seminal paper on “The Nature of the Firm” identified the costs associated with contracts and exchanges in a market. Modern business enterprise or firm as an efficient mechanism for coordinating the activities of the economy and allocating its resources took the place of direct market transactions. He pointed out that the costs of contracts and exchanges are lesser in a firm compared to markets. Thus, firms provide production and transaction cost efficiency. Coase concluded that whenever the costs of transaction will be lesser in a firm compared to markets, economic activities would be included within the firm.

Firms are formed to discipline the volatile market situation. It is generally argued that market through its price mechanism controls the economic situation but modern business enterprise took the place of market mechanisms in coordinating the activities of the economy and allocating resources. If, firms are not formulated then there would be several contracts among several individuals for production of goods which would made the system less efficient and risky. Firms act as a nexus of contracts. The firm is viewed as a set of contracts among factors of production, with each factor motivated by its self-interest. The firm is disciplined by competition from other firms. Alchian and Demsetz (1972) object to the notion that activities within the firm are governed by authority, and emphasize the role of contracts as a vehicle for firm governance. They emphasize the role of monitoring in situations in which there is joint input or team production. On the contrary, economic sociologists' give importance to authority in maintaining governance.

2.5.1 Separation of managers and owners

The rise of joint stock companies opened the doors for dispersed ownership which in turn initiated the problem of ownership and control. Modern business enterprise brought a new definition of the relationship between ownership and management. With dispersed ownership the responsibility of controlling and running a firm shifted from the owners (shareholders) to the managers (management). Management was efficient personnel who were appointed by the owners as agents to run the firm on behalf of the owners and these salaried managers were not always the shareholders or the owners of the company.

Alfred Chandler has argued in "The Visible Hand" that modern business enterprise has two specific characteristics: "it contains many distinct operating units and it is managed by a hierarchy of salaried executives that is the management." The managers are not the owners of the firms, but the shareholders. Managers' control and run the company where as shareholders' invest.

According to Berle and Means "the separations of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where

many of the checks which formerly operated to limit the use of power disappear.... In creating these new relationships, the quasi-public corporation may fairly be said to work a revolution. It ... has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.” Corporate share owners’ experience a loss of control over his resources because ownership is so broadly dispersed across large numbers of shareholders that the typical shareholder cannot exercise real power to oversee managerial performance in modern corporations. Management exercises more freedom in the use of the firm's resources than would exist if the firm were managed by its owner(s). Management and ownership interests do not naturally coincide provided they are the same person. Berle and Means perceive a conflict of interest, which, with dispersed ownership, is resolved in management's favor. Corporate wealth is used for personal gain other than profit maximization.

Michels (1911) opined that “the formal organization of bureaucracies inevitably leads to oligarchy, under which democratic organizations eventually become dominated by a small, self-serving group of people who achieved positions of power and responsibility.” In large organizations it is impossible for everyone to get together every time a decision has to be made. Consequently, a small group is given the responsibility of making decisions. Michels believed that the people in this group with power and elite positions become more inclined to make decisions that protect their power rather than represent the will of the group they are supposed to serve.

James Burnham in his book, “The Managerial Revolution” (1946) stated that “Capitalism is disappearing, but Socialism is not replacing it. The rulers of this new society will be the people who effectively control the means of production: that is, business executives, technicians, bureaucrats and soldiers.” Burnham called all of them the “managers”. “These people will eliminate the old capitalist class, crush the working class, and organize society in a way that all power and economic privilege remain in their own hands.” Dahrendorf in his book “Class and Class Conflict in Industrial society” (1959) stated that due to the rise of the joint stock company, ownership does not necessarily reflect control of economic production in modern society. Dahrendorf claims that authority becomes the fundamental division of class. He claims

that we must “replace the possession, or non-possession, of effective private property by the exercise of, or exclusion from, authority as the criterion of class formation”. Thus, society can be split up into the "command class" and the "obey class" and class conflict should refer to situations of “struggle between those with authority and those without”.

2.6 Agency Theory

According to Eisenhardt (1989) the most basic question “what is agency theory?” is subject to controversy. Authors such as Kiser (1999) and Shapiro (2005) have compiled different types of agency theories as found in the fields of economics, management, political science and sociology. Shapiro (2005) points out that the differences between these approaches are so significant that at some point the idea of coupling ‘agency’ and ‘theory’ becomes a problem. Nevertheless there is a common core to different disciplinary varieties of the theory of agency. For all these theories start from the condition that one party “acts on behalf of another” (Shapiro, 2005).

2.6.1 Agency theory in Economics

Adam Smith ([1776]1976:700) talked about agency problems in organizations, including those arising from the separation of ownership and control: “The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private company frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”

However, economists did not elaborate Smith’s insights on this topic for almost two centuries. The firm remained a “black box” in economic models and economic organizations were reduced to “production functions.” As Jensen (1983) describes the situation before the rediscovery of agency problems, “[i]n most economic analyses, the firm is modeled as an entrepreneur who maximizes profits in an environment in which all contracts are perfectly and

costlessly enforced.” Stiglitz (1987) pointed out that neoclassical economics “was based on the assumption that what action the ‘principal’ willed his agent to perform was perfectly known, and that the action could be perfectly and costlessly monitored. Neither assumption is plausible.”

Agency theory emerged after the “new institutionalism” (sometimes called the “new economics of organization”) in economics began to open up the black box of the firm, with a new focus on property rights (Cheung 1969; North 1981; Barzel 1989), transaction costs (North and Thomas 1973; Williamson 1976, 1985), and agency problems (Ross 1973; Jensen and Meckling 1976).

Economic agency theorists have used micro foundations and simple models of organizations to understand agency problems and the role of monitoring and incentive schemes to reduce agency cost and increase organizational efficiency.

Agency theory in economics was initiated by the work of Berhold (1971), Ross (1973), and especially Jensen and Meckling (1976). They addressed problems that generate out of information asymmetries between agents and principals. Berhold (1971) focuses on the relation between contract choice and risk preferences and the effects of different monetary incentive schemes on performance. These two issues have continued to be the main focus of economic theories of agency. Jensen and Meckling (1976) develop the model much more fully, and apply it to the problem that comes from the separation of ownership and control. Jensen & Meckling (1976) assert that “most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals”. According to Fama and Jensen (1983) “An organization is a nexus of contracts, written and unwritten, among owners of factors of production and agents. These contracts or internal “rules of the game” specify the rights of each agent in the organization. According to this paradigm, agency relationships is a contract under which one or more persons (the principal(s)/shareholders) engage another person (the agent/management) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interest of the

principal thus the principal has to incur certain agency costs. The separation of ownership and control in the modern diffused ownership corporation are intimately associated with the general problem of agency. The agency cost is the sum total of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.”

Another important aspect of economic theory of agency is the concept of “risk” . Economists recognized that agency relations involve not only problems of control but issues of risk-sharing as well. Risk aspect of agency differentiates between efficient and inefficient contracts. However, the advantage of including risk in the theory is often lost when the mathematical models are constructed. Mathematical models are developed on the assumption of risk neutral agents.

According to economic theory of agency, agent selection is a critical aspect of agency problem. Improper selection can lead to agency problem. There are different “types” of agents, meaning that agents differ in their general levels of ability, effort, and honesty. These differences are better known to agents than to principals, another aspect of the information asymmetry between the two, which creates the problem of wrong agent selection and hence agency problems. Economic agency theorists have made two main arguments about agent type. The first is that principals can affect the type of agents they get by the form of the contract they offer, since agents, knowing their own “type,” will select the contract most beneficial to them. For example, low productivity agents will choose fixed salaries, whereas high productivity agents will choose piece-rate contracts. The second main argument comes from the related literature on “signaling” (Spence 1973). Sellers of high quality products (such as high productivity workers seeking employment) will attempt to reveal their “type” by undertaking some activity that is less costly to them than it would be to someone selling a low quality product.

2.6.1.1 Strengths and Limitations of Economic Agency Theory

The main criticisms of economic agency theory come from the Sociologists for being unrealistic and narrow. Petersen (1993), MacDonald (1984), and Eisenhardt (1989) all agree that

agency theory as used by economists is too narrow, and that it can and should be broadened to include additional elements.

There are several limitations of economic agency theory. The first limitation comes from its dyadic model of organization. As Kiser (1999) observes, classic agency theory “is an organizational theory without organizations.” In fact, the typical “organization” in agency models consisted of only two actors, one principal and one agent. The problem with using such simple models is that they are unrealistic. Shareholders of corporations are multiple principals, and employees are multiple agents—and these facts are often critical for understanding agency relations (multiple employees can engage in collusive corruption, for example, or they can either report or hide the shirking of other employees).

According to Shapiro (2005) “the CEO may be an agent of the shareholders and the board, but he or she is simultaneously the principal in a long chain of principal-agent relationships both inside and outside the corporation..... Moreover, the assumption of a solitary principal and agent is abstract.... Real organizations include multiple principals and agents. Theories become much more complex when they allow for the possibility that collections or teams of principals (or agents) disagree or compete over interests and goals.” Adams (1996) dubs it as the “Hydra factor.” Shapiro further points out that “how do agents understand and reconcile the duties delegated to them when they are receiving mixed messages and conflicting instructions—and incentives—from multiple principals?” How do agents perform their duties when the contract is vague by design and there are irreconcilable differences among principals with conflicting interests? When do these collective action problems faced by principals give agents opportunities to play one principal off against another?

Multiple agents who have been delegated to undertake a task collectively add other dimensions to the economists’ models. Agents, too, have competing interests. Interests of some agents are more similar to their principals than with the other agents. Some agents shirk more compared to others; different modes of incentives work differently on different agents. “The existence of multiple principals and multiple agents sometimes increases the informational asymmetries and the difficulties of monitoring...These information

asymmetries are among the reasons organizational crimes can flourish undiscovered for long periods of time buried in complex structures of action” (Waterman & Meier 1998, Shapiro 2005).

Agency theory in economics has focused on two main types of agency relations in economic organizations—between shareholders and managers, and between employers and employees. Because of this constrained empirical scope and the desire to deduce mathematical models, economists have focused on a limited range of monitoring and sanctioning strategies.

Economic agency theorists have also focused on a limited range of incentives, usually various forms of monetary incentives and sometimes including the threat of dismissal as well. Several organizational sociologists’ argue incentives such as self-actualization, acknowledgment for contribution and other non-economic rewards work better than monetary incentives as a source of motivation.

Another limitation of the economic theory of agency comes from the fact that the theory deals with the problem of agency only from the agent’s side and not from the side of the principal. Perrow(1986), for example, accuses the economics paradigm of being “incapable of keeping its eye on both sides of the principal-agent relationship. Agency problems are recognized only from the agent side of the relationship and are mirrored on the principal side.” He observes that it is possible that there are principals who shirk, cheat, and opportunistically seize perquisites for their own use. This he terms as “owner opportunism.” These principals can purposefully select inefficient agents and exploit their agents. Perrow argues that economic agency theory is blind to the asymmetries of power which is profoundly conservative, even dangerous. Perrow (1986) also rejects the assumption that agents are always work averters, self-interested utility maximizers. He faults economic agency theory for its inattention to the cooperative aspects of social life. This critique is continued in what has become known in the management literature as “stewardship theory”. Stewardship theory views “agents as good stewards and team players and replaces assumptions of opportunism and conflict of interest with those of cooperation and coordination” (Donaldson 1990).

Finally, scholars from varied disciplines outside of economics also abandon the assumption of an acontextual, ahistorical, and static relationship between principals and agents (Mitnick 1992). Agency relationships are embedded in a broader social context and are influenced by outside forces and other agency relationships like competitors, interest groups, regulators, legal rules, and so forth. “Relationships endure over time, affording principals and agents get to know one another. Principals learn better which incentives are likely to work. Agents learn more about the preferences of the principals they serve. They develop reputations. Relationships become embedded as parties develop histories and personal relationships and become entangled in social networks, by doing this, the balance of power between principal and agent may shift” (Shaprio 2005, Granovetter 1985).

2.6.2 Agency theory in Management

The agency theory paradigm of economics literature has diffused into the management literature, by the early 1990s, representing a new and dominant institutional logic of corporate governance (Zajac & Westphal 2004). “Corporations adopt policies, explicitly invoking agency theory about aligning incentives and discouraging self-interested behavior by managers, and reducing agency costs” (Zajac & Westphal 2004).

The most popular stream of management literature focuses on incentive alignment, particularly compensation policies. A second stream examines “corporate governance and control”, such as the “monitoring role of the board of directors” and “trade-offs between recruiting inside or outside directors” or between “separating the roles of board chair and CEO versus filling them with one individual”; “monitoring strategies within the firm” “bonding mechanisms” etc. The literature also includes studies of the process and costs of searching for agents, especially in light of the tensions posed by adverse selection.

2.6.3 Political Science and Agency theory

Political scientists try to understand agency related problems, like adverse selection and information asymmetry in the realm of political environment. The political system is a complex network of several actors like citizens, lawmakers, political leaders etc.

“Agency theory in political science borrows heavily from the economics paradigm”(Kiser 1999).The outlines of the agency paradigm in political science are the same as those in the economic version: agents (elected leaders) carry out political duties for the principals (citizens). The agents have the authority and like economic agency the same conflict of interest and information asymmetry exist between the principals and the agent in a political market. The details are quite different. Unlike economists, political scientists assume multiple agents and principals and also give more attention on recruitment and monitoring of agents. There are literature as to when agency costs are highest and what the difficulties in motivating an agent’s behavior are.

2.6.4 A sociological perspective of agency theory

Kiser (1999) observes that, compared to the other two disciplines, “the use of agency theory in sociology is in its infancy” and comes from a rather different “intellectual genealogy”, largely the work of Weber (1924/1968).

Empirical work in sociology that explicitly adopts an agency theory perspective (apart from that described in the organizational behavior and management literatures) can be found in qualitative comparative historical sociology. From Asian tax administration, we learn about “the tensions between principals and agents, conflicting interests, opportunism, informational asymmetry, agent selection, monitoring, sanctions, incentives, and agency costs” (Adams 1996, Kiser 1999, Kiser & Cai 2003). This work links social structure to agency relations.

In a series of papers spanning at least 25 years, Barry Mitnick broke the monopoly on agency theory enjoyed by the economics paradigm. Agency, he argued (Mitnick 1998) is simply “a general social theory of relationships of ‘acting for’ or control in complex systems.” Mitnick observed agency relationships have two faces, “the activities and problems of identifying and

providing services of ‘acting for’ (the agent side), and the activities and problems of guiding and correcting agent actions (the principal side).” Of course, both faces of agency entail costs and most of the times neither for the principal nor for the agent perfect behavior seem feasible. So “perfect agency” is rare, and deviant behavior is likely to “persist and be tolerated.” Agency theory, then, “becomes a study in the production, the persistence, and the amelioration of failures in service and control” (Mitnick 1998).

Agency or “acting for” relationships arise from a number of sources, including

1. The division of labor; we simply do not have time to do everything ourselves (even hunting and gathering), and we need to depend on other people for complex tasks. Thus, we need other actors who can act for us. [Mitnick (1984) calls this practical or structural agency].
2. Some people acquire or have access to specialized knowledge, so other actors depend on them. [Mitnick (1984) labels this contentful agency].
3. The impulse to collectivize in order to enjoy economies of scope and scale or protection from risk leads to interdependence, which in turn brings agency. [Mitnick (1984) calls this systemic or collective agency].

These varied occasions reflect different agency related problem. Below I have discussed some themes of sociology where we can find an application of agency theory.

2.6.4.1 Professions

The sociology of the professions provides a solution to the problem of adverse selection and asymmetric information. “Professions boast careful and competitive selection procedures. They offer training and credentialing, licensing and mandatory continuing education to solve the principals’ problem of adverse selection. They may even establish protocols or specify best practices to limit agent discretion. They create ethics codes to curb the self-interest and

opportunism of practitioners” (Heimer 1985, Davis 1996). Professions are social devices to limit agency costs.

2.6.4.2 Goal Conflict

The economic agency paradigm, because of its dyadic setup and importance to principal, perceives goal conflict as the departure of agents from the interests of the principal. Hence, the solution to this agency problem is to come up with incentives that will align the interests of agents with those of the principal. The agency problem looks quite different from the perspective of the agent. Conflicts between the interests of the agents and those of the principal are the least of the agent’s problems. The real problem is that the agent is most likely serving many masters, many principals with conflicting interests. So the problems of agents are to decide how to honor the preferences of one when doing so means that you are undermining the interests of another? How to choose among often incommensurable and competing demands of several principals (Espeland & Stevens 1998)?

Only the rare agent has the opportunity of aligning his interests with a single principal. Conflict of interest is hardly about shirking or opportunism; it is about handling different interests of multiple principals by agents. “Economic agency theory misunderstands not only the source of goal conflict but also the social conditions that inflame it. Examining how the social organization of agency relationship gives rise to conflicting interests and how agents (institutional as well as individual) in diverse settings and roles respond is a subject for sociological inquiry” (Shapiro 2003).

2.6.4.3 Opportunism

Economic agency theory does not explain clearly the nature of agency problem. The paradigm does not say as to what agents are up to when they act opportunistically. Sociologists have been studying these agency problems at least since Edwin Sutherland (1940) coined the term “white collar crime”, but ofcourse there is no clear cut definition of “white collar crime.” Many would probably agree that misdeeds committed by individual or organizational agents come fairly

close to what they consider to be white-collar crimes. Sociologists have and will continue to make an important contribution to understandings of white-collar and corporate crime (Shapiro 2001).

2.6.4.4 Monitoring

There is, of course, an abundance of work in sociology on social control, compliance, organizational governance, policing, and sanctions that will contribute to understanding the agency paradigm. These literatures demonstrate that the nature of white collar crime is very different from any other type of crime. The control mechanism for while collar crime work in a specific way and is not applicable to any other crime.

2.7 Agency Cost

However hard principals try to minimize them, all agency relationships experience agency costs; about this all the paradigms agree. Agency costs arise from several sources: information asymmetry, adverse selection, shirking, corruption, monitoring etc. Because principals cannot observe agent behavior, they “rely on imperfect surrogate measures, which can lead the agent to displace his behavior toward the surrogates in order to appear to be behaving well” (Mitnick 1992).

Agency Costs increase because organizations are structured to minimize opportunism— checks and balances are created, reporting requirements implemented, employees rotated, responsibilities fragmented, layers of supervision added and so on. How do principals make investment decisions about agency costs? what kind of agency relationship is most costly ? Aside from embedding agency service in ongoing social relationships, what strategies do principals employ to minimize agency costs? When do principals do not monitor at all? A systematic understanding of corporate governance mechanisms gives answer to these questions. To minimize agency cost corporate governance plays a very important role.

2.8 Corporate Governance

The corporate governance literature is dominated by the economic interpretation of corporate governance. The importance of corporate governance comes from the agency problems. Corporate governance tries to reduce the agency cost which comes from the separation of ownership and control. Investors in corporations require assurance that their contributions financial capital, human capital, social capital will generate a return. Thus, corporate governance consists of "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they under take are allocated" (Blair 1995). "In a narrow sense, corporate governance specifies the relationship among various primary participants (shareholders, directors, and managers) in determining the directions and performance of corporations. In a broader sense, it delineates the rights and responsibilities of each primary stakeholder and the design of institutions and mechanisms that induce or control board directors and management to best serve the economic interests of shareholders (and other stakeholders) of a company. Many of these other stakeholders also play a role in monitoring the behavior of the board/management"(National foundation of Corporate Governance).

The board is the most important part of any organization. The board takes all the decisions for the company. Thus, the board has the most control over the governance structures of any organization. The essence or attributes of good corporate governance include "ethics, managerial discipline, board independence, protection of shareholders' rights, fairness, transparency, board responsibilities, accountability, and social awareness." One major corporate governance principle of OECD (Organization for Economic Cooperation and Development) is to "focus on the company rather than on one group of people."

Theoretical and applied work on corporate governance systems point to the importance of the structure of ownership and control in setting the background for the corporate governance issues that can arise in reality. Three aspects that need to be considered are the structure of ownership and its concentration; the instruments of control and exercise of control.

2.8.1 Two alternative concepts of the corporation and of its governance: Shareholder vs. Stakeholders' perspective

Both the shareholder' and stakeholder theories delineates the duties and responsibilities of a corporation. The two theories have different take on what is "right". Shareholders' theory asserts that shareholders invest money in a corporation, thus the most important responsibility of the management is to make sure that the investment is protected from misuse. As Milton Friedman wrote, "There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it ... engages in open and free competition, without deception or fraud." The corporation belongs to shareholders and should be run in their interest. Thus the objective of the management should be to maximize the market value of the company.

On the other hand, stakeholder theory asserts that managers have a duty to both the corporation's shareholders and "individuals and constituencies that contribute, either voluntarily or involuntarily, to [a company's] wealth creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers" (Freeman, 1991). The corporation must be run in the interest of stakeholders. There are debates concerning which group or individual can be truly termed as stakeholders of a company. As the interest of stakeholders is various and contradictory, a compromise between the pursuits of the various interests should be found. Although there is some debate regarding which stakeholders deserve consideration, a widely accepted interpretation refers to shareholders, customers, employees, suppliers and the local community.

The fundamental distinction between shareholders' model and stakeholderes' model of governance is that the stakeholder theory demands that interests of all stakeholders be considered even if it reduces company profitability. Shareholders' theory on the contrary gives precedence only to the interests of the shareholders and suggests that companies should not compromise on its profitability aspects. Unfortunately, shareholder theory is often misrepresented in several ways. First, it is sometimes misstated as urging managers to "do anything you can to make a profit," even though the shareholder theory obligates managers to

increase profits only through legal, non deceptive means. Second, some criticize that shareholders' theory is focused only toward short-term profit maximization at the expense of long term goals. However, more thoughtful shareholder theorists often refer to a need for "enlightened self-interest," which — if embraced — would lead a corporation's managers to take a long-term orientation. Third, it sometimes claimed that the shareholders' theory prohibits a company from doing any charitable project or investing in improved employee morale, but that is not true. Similarly, the stakeholders' theory is sometimes misunderstood. It is sometimes claimed that the stakeholder theory does not demand that a company focus on profitability. Even though the stakeholders' theory clearly states that shareholders are stakeholders of the company. It is the duty of the management to give proper importance to the interests of the shareholders' by addressing it through profits. Also, because stakeholders' theory does not provide a framework on how to balance diverse interests of different stakeholders' the theory is considered as impractical and impossible to implement.

2.8.2 Corporate governance and the agency theory

Researchers traditionally study corporate governance within the framework of contractarian/economic approach of agency theory, viewing the modern corporation as a nexus of contracts between principals (risk-bearing shareholders) and agents (managers with specialized expertise). Given the potential separation of ownership and control (Berle & Means, 1932), various mechanisms are needed to align the interests of principals and agents (Fama, 1980; Fama & Jensen, 1983; Jensen & Meckling, 1976). "Agency costs arise because shareholders face problems in monitoring management: they have imperfect information to make qualified decisions; contractual limits to management discretion may be difficult to enforce; and shareholders confront free-rider problems where portfolios are diversified, thereby reducing individual incentives to exercise rights and creating preference for exit" (Eisenhardt, 1989). Thus the function of corporate governance is to reduce agency costs.

As stated earlier ownership structure is closely related with agency theory. Thus governance structures differ from one market to another as ownership structure differs from market to market. For example, the United Kingdom and United States are characterized by dispersed

ownership where markets for corporate control, legal regulation, and contractual incentives are key governance mechanisms. In continental Europe and Japan, blockholders such as banks and families retain greater capacity to exercise direct control and, thus, operate in a context with fewer market-oriented rules for disclosure. Agency theory fails to account for key differences across countries. Corporate governance concerns “the structure of rights and responsibilities among the parties with a stake in the firm” (Aoki, 2000: 11). Yet the diversity of practices around the world nearly defies a common definition. “What the salient national differences in corporate governance are and how they should best be conceptualized remain hotly debated” (Gedajlovic & Shapiro, 1998; O’Sullivan, 2000; Pedersen & Thomsen, 1997; Prowse, 1995; Shleifer & Vishny, 1997; Thomsen & Pedersen, 2000). Researchers mostly concentrate on two different models of corporate governance the “Anglo-American” and “Continental European model” of corporate governance (Becht & Roel, 1999; Berglöf, 1991; Hall & Soskice, 2001; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998). “They stylize the former in terms of financing through equity, dispersed ownership, active markets for corporate control, and flexible labor markets, and the latter in terms of long term debt finance, ownership by large blockholders, weak markets for corporate control, and rigid labor markets. Yet this classification only partially fits Japan and other East Asian countries” (Dore, 2000; Gerlach, 1992; Khan, 2001; Orru, Biggart, & Hamilton, 1997; Whitley, 1992), the variations within Continental Europe (Barca & Becht, 2001; Rhodes & van Apeldoorn, 1998; Weimer & Pape, 1999; Whittington & Mayer, 2000), Eastern Europe (Martin, 1999; Wright, Filatotchev, & Buck, 1997), and multinational firms (Fukao, 1995). Despite the rich description found in this research literature, the challenge remains to conceptualize cross-national diversity and identify the key factors explaining these differences. Until very recently, studies in corporate governance were almost exclusively connected with advanced market economies with sophisticated capital markets. Yet the problem of corporate governance is very different in transitional and emerging economies. India’s growth rates have been amongst the highest in the world since its economic reforms. Its market infrastructure has advanced. This growth brings with it an acute need to understand the dynamics of corporate governance prevailing in Indian context. An examination of corporate governance issues, especially those concerning ownership structures and performance is very important and can yield important insights to the literature on corporate governance

The legal and regulatory system of a country plays a crucial role in creating an effective corporate governance mechanism in a country, the development of markets and economic growth. For example-“The regulatory framework of corporate governance consists of the Companies Act, the Securities and Exchange Board of India (SEBI) Act, 1992, the Securities Contracts (Regulation) Act, 1956, Sick Industrial Companies (Special Provisions) Act, 1985 and the Listing Agreement”. It is quite evident that the regulatory bodies in India have advocated rigorous corporate governance reforms, but there are certain gaps in its implementation.

The major governance challenge in India is unaddressed conflicts between the dominant shareholders and the minority shareholders. Since board derives its power from dominant shareholders, disciplining the latter by the former is not feasible resulting in the ineffectiveness of the board. There thus exists a dual challenge of resolving conflict between not only the shareholders and management but also between dominant shareholders and minority shareholders.

Despite giving trust importance as a source of social capital in the literature, embeddedness also has a dark side. Family firms, for example, face unique agency costs. “They struggle with adverse selection because nepotism can lead to the selection of less-capable agents. Moreover, because family members are often compensated generously regardless of merit, and their job tenures are relatively secure, principals lack important incentives to constrain agent behavior hence, the risk of shirking and free riding by family agents increase. Because embeddedness is often an excuse to relax vigilant recruitment and monitoring, it provides cover, not only for wayward offspring or relatives, but also for confidence swindlers to feign social intimacy and thereby enjoy unfettered opportunism” (Shapiro 1990).

The sociological approach of agency theory tries to relate the connection between politics and governance from a historical perspective. Fligstein's (1990) in his book *The Transformation of Corporate Control* pointed out that “corporations are embedded in a field of other organizations, including buyers, suppliers, competitors, regulatory agencies, and others, with

their own strategies and structures reflecting their own internal power struggles; and that the state defines the rules of the game for their interaction, generating conditions either for turbulence or order.” Fligstein (1990) provides a four-part periodization of the history of the large American corporation. He argues that government as a stakeholder shaped the governance of corporate America over the years by introducing different rules and regulations which changed the ground rules of competition and thus generated a search for new strategies and structures. The links between state regulation and organizational action are conceptions of control "totalizing world views that cause actors to interpret every situation from a given perspective. They are forms of analysis used by actors to find solutions to the current problems of the organization" and are "collectively held and reflected in their organizational fields" (Fligstein 1990). “Direct control, the first conception of control, used predatory competition, in the late nineteenth century. The manufacturing conception of control sought oligopoly through horizontal mergers (acquiring competitors) and vertical integration (buying suppliers and distributors). When these tactics became problematic, the sales and marketing conception of control took off in the 1920s, focusing on product differentiation and line extension, advertising, and related diversification. Finally, the finance conception of control was encouraged by the Celler-Kefauver Act and promoted the rapid spread of the diversified conglomerate” (Fligstein 1990).

More recent work has also examined the operations of specific current corporate governance mechanisms, such as boards of directors, managerial labor markets, financial analysts, and so on, and uncovered stark divergences from the law and economics view. “A related line of work examines board dynamics and compensation practices, including power relations within boardrooms (Gulati & Westphal 1999, Westphal & Poonam 2003), practices for replacing CEOs (Ocasio 1999, Thornton & Ocasio 1999), and the origins of innovations in pay” (Westphal & Zajac 1994). Third line of research examines “ownership and changes in control, documenting how different categories of owners’ families, banks, or other financial institutions pursue different agendas through their influence on corporate strategy” (Davis & Stout 1992; Palmer & Barber 2001; Kang & Sorenson 1999 for a review).

Although these studies provide useful insights regarding corporate governance they have failed to provide a proper alternative to the law and economics approach. More importantly, none of the approaches have given adequate importance to the governance challenges perceived in the developing economies.

2.9 Conclusion

New Economic Sociology (NES) and New Institutional Economics (NIE), both deal with organizations. The major difference between these two schools is regarding their understanding of motives of human actions (including rational choice). NES gives importance to social phenomenon like trust and authority whereas for NIE self interest is the only motive behind all human actions. NES also try to understand the motivation of an individual's economic action in relation to another individual's action, as according to them economic action is a special kind of social action on the contrary NIE looks human action in isolation. NES tries to perceive agency theory and corporate governance from a perspective of multiple actors influencing each others' action.

Whatever be the motivation of individual action, there is no place to deny the widely accepted influence of transaction costs even the strictest neoclassical economist should accept today the idea of a market as a network of people, knowing each other personally, as something "good" and not necessarily "bad" (encouraging collusion instead of competition). "The basic difference in the models of man of NES and NIE might shrink further, or even fully disappear, with future advancements in the biology of human social behavior" (Robson 2001). In the course of time NES and NIE may merge into some "NSE" (New Socio-Economics).

CHAPTER-3 : RETAIL INDUSTRY

3.1 Introduction

The business of retailing involves selling products and services to consumers. Consumers can be either individual customers or another business enterprise. Retailing provides a link between the consumers and manufacturers. From the point of customers retailing provides them with all the choices of products available at a given point of time as it keeps products from different manufacturers. From the point of manufacturers it can simply sell their products to a retailer and do not worry about the customers. Retailers' make the art of selling and buying much easier. It is not possible for an individual customer to go and buy the necessary products from several manufacturers. It is equally difficult for manufacturers to reach individual customers. It is an inefficient and time consuming process. Retailers help several customers to choose from several products manufactured by the manufactures, making the business of selling and buying a more efficient and cost saving one.

Retail industry is one of the most important sectors for Indian economy. Retail is presently the largest employer after agriculture. According to A T Kearney's Global Retail Development Index (GRDI) 2012 "India is the 5th most favorable destination for international retailers. Of the total Indian retail market, 8% constitutes the organized retail segment which is estimated to grow at a rate of almost 30% by 2015, and hence at a much faster pace than the overall retail market which is forecast to grow by 16% in the same period. India currently has a small penetration within the organized retail segment as compared to other emerging markets such as China, which has a penetration of more than 20% within organized retail."

3.2 History of Organized Retailing in India

Retailing is an old activity. Over the centuries civilizations, have developed with the growth of trade and commerce. Trade and commerce has influenced urbanization. Market places have always been a place where people come together, interact with each other at the same time buy all the essential products. Modern retailing also tries to enhance the community life of people.

Although the “shopping-entertainment-lifestyle” formats the modern retailers follow does not work exactly like the traditional market place. Nevertheless, modern retailing is inspired by the philosophy of street shopping along with community-centric activity.

For many years, the Indian government protected local retailing from foreign competition. As retailing is the biggest source of employment in India after agriculture, it was felt that protecting small scale retailing is important. It was felt that with the rise of big retail houses small retail owners will perish. This is why the retail market has remained less developed. The retail market in India, today, is still mostly populated by small owner managed local shops (kirana stores) and by local street markets. The emergence of organized retail in India dates back to pre- independence era. A report titled “India Report: Retailing Reality” by Cushman & Wakefield (2010) classified the history of Organized retailing in India in four phases.

- “Initiation(pre 1990’s)
- Conceptualization (1990 to 2005)
- Retail expansion (2005-2010)
- Retail consolidation (2010 onwards)”

Retail initiation- The ear of modern organized retailing in India started with textile manufacturers as part of their forward integration process opening up exclusive retail outlets. Most of the major textile manufacturers were retailers. According to the report “ the key players in this era included Bombay Dyeing, The Raymonds group, The S Kumars group to name a few. Central and State government departments and co-operatives bodies such as the Public Distribution System, Mother Dairy, Kendriya Bhandar, Super Bazar etc., played a key role in the Indian retail market as prominent retailers” (Cushman & Wakefield, 2010). During this period apart from the textile majors some food and grocery (F&G) retailers entered the retail market. These grocery retailers made their inception in south India as some regional retailers but, afterwards those regional players managed to establish themselves nationally. The report says “Bangalore based Nilgiri’s started as a bakery chain Nilgiri Dairy Farm. Today, Nilgiri’s is one of the finest retail chains in south India that works on both company owned and franchisee store models. Another major F&G player Foodworld, was the first national retail chain from the RPG group. Despite being a Kolkata based business house the first Foodworld supermarket was set up in Chennai in 1996.”

These few stores remained as the only organized retailers for a long period of time. The post 1990 period saw a fresh wave of entrants in the retailing business.

Retail conceptualization- With liberalization taking place in the 1990s, India saw a new era in retailing business. During this time apart from the manufacturers venturing into retail, independent retail started in India. Mostly big business houses started investing in retail. Some of the big names during that time were Pantaloons, Shoppers' Stop and Lifestyle. "It is interesting to note that most new retailers in this era focused mainly on apparel and other related fashion categories. An important occurrence during this time was the liberalization of the Indian economy and the opening of entry opportunities for international brands/retailers. The first generation of foreign brands to make Indian entry during this phase included MacDonald's, Benetton, Levi Strauss, Adidas, Reebok, Nike, to name a few" (Cushman & Wakefield, 2010).

Retail expansion- With the rise of per capita income and disposable income post liberalization, this phase was the most active phase in the history of modern Indian retailing. The growth of retail industry in terms of numbers, formats, and investments during this time was phenomenal. Several new companies ventured into retailing during this period.

"Having realized the potential of the relatively untapped domestic market, large Indian conglomerates like Mahindra and Mahindra, Reliance, Tata, Aditya Birla and Essar entered the Indian retail arena during this period. Most of these groups committed large investments in the retail sector and planned to establish pan-Indian brands which enjoyed significant success in the years that followed. Their success brought in global retailers such as Metro AG, Max Retail, Shoprite, Hypercity, etc and more recently Tesco, Zara and Carrefour that announced their India entry and are optimistic about their growth in this market; others like Bharati-Walmart, SPAR, Debenhams and Mother Care have already established their presence here....The period saw the emergence of new formats like cash and carry, large format discounters, food courts, multiplexes, children's play zones and gaming zones." (Cushman & Wakefield, 2010).

Looking at the rapid growth of the retail market around this time global luxury brands entered into the organized retail market. With a growing disposable income premium, international luxury brands identified India as an attractive destination for investment. “The most important category for luxury goods consumers soon became interested in was high-end automobiles, electronics, and other home improvement products, besides fashion, lifestyle and fine dining. Global luxury brands (such as Louis Vuitton, Hugo Boss etc.) were selectively available in India from the late 1990’s but till about 2005 these were entailed only through franchisee agreements, in the absence of any policy permitting Foreign Direct Investment (FDI) in single brand retail. With the FDI policy 2005-2006 allowing single brand foreign retailers to take up to 51% stake in a joint-venture with a local firm, the intervening years saw entry of several premium brands (Gucci, Giorgio Armani, Versace etc.) mostly through joint ventures” (Cushman & Wakefield, 2010).

Retail Consolidation- The current phase can be characterized as a phase of consolidation. The most important concern for most of the retailers today is to cut cost and survive the market phase now anticipated as retail consolidation. It is a phase when retailing as an industry is becoming more mature and focused. Companies are interested in strengthening their operations, while considering growth options through consolidation.

3.3 Retail Organizations: A profile

Indian retail sector is highly fragmented with a major chunk of its business being done by the unorganized retailers like the family run stores and the corner stores. Around 8% (according to Indian retail report 2013) of the total retailing done in India falls under the rubric of organized retailing rest 92% of retailing is still done through unorganized retailing. Clothing and apparel is the largest section of organized retailing. Other important segments of organized retailing are “Food and Grocery” and “Mobile and telecom”

Food and Grocery: This is the largest segment of retailing in India. According to McKinsey report maximum share of an Indian household spending is on food and grocery. 60% percent of

total retail share compromise food and grocery. The food and grocery business in India is largely unorganized. Most food is sold in local markets, vendors, push-carts, or in tiny kirana shops. As stated above only 8 % of the total retailing market is organized 11% of the organized market is occupied by food and grocery segment, but only 1 percent of total food and grocery market is organized. Supply chain deficiency affects the food retailing resulting in around 40% loss of farm produce. Hypermarkets and supermarkets are best suited formats for food and grocery retailing.

Apparels: Clothing and textile is the biggest organized segment. 33 percent of the total organized retail market consists of apparels retailing. A Major share of the total organized retail market falls under apparels retailing. Out of the total retail market in India clothing and textile retail market share is 11 percent, but in apparels market 20 percent of retailing is done through organized retail chains. Thus, the penetration of organized retailing in the apparel section is high compared to other sections. The ready-mades and western outfits are growing very fast annually, as the markets' teams up with international brands and new entrants are entering into this segment.

Telecom and mobile: 4% of the total retail market is telecom and the mobile market. Out of the total organized retailing market mobile and telecom holds an 11% market which is growing fast.

3.4 Different Retail Formats in India

There are various retail formats available in India. First of all retailing in India can be classified as organized retailing and unorganized retailing. Under organized retailing there are several formats, but one has to remember that these classifications are not exclusive and they overlap each other.

3.4.1 Unorganized Retail Formats

We have seen in the previous section that retailing in India is largely unorganized retailing. The term “unorganized retail” becomes more clear when we compare this form of retailing with the more developed organized form of retailing. The main features of unorganized retailing are:

- 1) These are mostly run by family members. Family becomes the business unit.
- 2) From inventory management to supply chain management, everything is done by the owner of the store manually.
- 3) It is a small store managed by one or two family members.

Some formats of unorganized retailing are Kiranas or food and non-food neighborhood counter stores, Mandis, Village haats, Push cart vendors, etc.

3.4.2 Organized Retail Formats

Organized Retail formats refer to supermarkets and hypermarkets prevalent in most developed countries. There are several formats available in the organized retail sector. They can be categorized as store format by location like high street format and convenience stores: store format by ownership like franchise format and Independent store format. Organized retail stores can be categorized based on their merchandise category like specialty store, department store, supermarket, hypermarket, etc. Apart from these there are some other organized retail formats like Haryali Kisan bazaar, cash and carry wholesale model, malls, etc.

3.5 Challenges before Retailing in India

There are major challenges faced by organized and unorganized retailing. The unorganized sector has easy entry and exit. Entry to the retail sector is easiest compared to any other industry. Small unorganized shops, popularly know as the kirana shops are the easiest way to enter the retail sector. It is a self-employment initiative and it requires very little investment. The major problem with an unorganized market is that, they lack on technology due to financial constraints which often becomes the main cause behind out of the stock problem. Although compared to organized retail, the problem of out of stock is lower in kirana stores. But the major problem is the quantity and choices of products are very low in small shops compared to

big organized retailers. Due to long distribution channels the profit margin is also low. Low penetration of technology prevents them from functioning faster and also they have the storage problem. Due to low investments, the unorganized sector cannot invest in technology like SAP or ERP, which helps in the logistics and supply chain of the firm. For growth, the most important factor is money, which is often lacking in the unorganized segment. They mostly run on very low net profits since they do not have a fixed amount of customers walking in the store; hence, they are unable to invest in space and technology. They are short of staff, because they only have the owner and one more person handling the store, resulting in longer waiting periods for customers and loss of business at times. With many organized retailers reducing and bargaining with leading manufacturers, they can offer higher discounts and pass on this benefit to the stores. The higher the number of products purchased, the higher is the discount. Many retailers also run promotions on food grains and give offers like 'buy one get one free', which an unorganized player cannot afford to do. Since organized retailers are run by large business houses, investing in space is not an issue. They usually have a variety of brands and private levels under one roof. This helps them to provide the customers a variety of products to choose from.

While the challenge for unorganized sector comes mainly from organized retailing, there are different kinds of challenges for organized retailing in India.

3.5.1 Government restrictions on FDI (Foreign Direct Investment)

For many years retailing was protected by the government. FDI was not allowed in retailing. In order to prosper any business needs money infusion. Thus finance was very important for the growth of the organized retail sector. It was during liberalization the door for FDI in retail was opened, but partially with a lot of restrictions. Organized retailing in India is still in an early stage in India in terms of its infrastructural and technological. Before 2011 foreign investment was not allowed for multi-brand retailing in India. Foreign companies were barred from investing in Indian supermarkets or any other retail outlets.

“The Government of Manmohan Singh, prime minister, announced on 24 November 2011, the following:

- India will allow foreign groups to own up to 51 per cent in "multi-brand retailers", as supermarkets are known in India, in the most radical pro-liberalization reform passed by an Indian cabinet in years.
- Single brand retailers, such as Apple and Ikea, can own 100 percent of their Indian stores, up from the previous cap of 51 percent;

The new FDI policy implies greater autonomy in functioning for foreign single-brand retail players who can now own 100% of their Indian stores, up from the previous cap of 51% with only the stipulation that they will have to source 30% of their goods from small and medium-sized Indian suppliers. The new policy allows a maximum 51% ownership for the multi brand retail sector.”

Source: DIPP (2012 series) Policy on Foreign Direct Investment-Liberalization of the policy in Single-brand retail trading

3.5.2 Lack of a uniform tax and regulations

India's complex and non-uniform tax structure comes in the way of the development of organized retailing. VAT structure, local and extra taxes vary from state to state, which results in different pricing of the same product in different parts of India. All these coupled together makes production cost different in different states, thus the development of organized retailing also varies from state to state. Maximum Retail Price (MRP) fixed by the manufacturers too affects the retailer as the profit margin is decided by the manufacturer. A different distribution network with their complex tax structure makes situations complicated for the retailers. It badly affects the supply chain of retailers. The success and failure of retailing depends largely on its supply chain, as retailers have to source good from far off locations. In India different state has different tax structure. This differential tax regime negatively affects the retailer, while sourcing goods from different locations. This hampers the growth of any retail chain. The need of the hour in a centralized tax structure as the regional disparity in production of commodities is very high. Currently, multiple tax structures and multiple tax enforcement authorities make situations even more complicated for retailers. Today to open one department store or a supermarket the retailer has to take several permissions from several authorities which take a lot of time in the commencement of business.

3.5.3 Lack of adequate infrastructure, Supply-Chain constrain

Proper supply chain management is very important for the growth and development of retailing. In India numbers of logistics, companies are very less; as a result organized retailers are forced to set up their own infrastructure. Modern organized Indian retailers have shown lesser interest in investing in back end and supply chain operations, and their investments are mostly into the front end. It is now important for retailers to think supply chain management from a strategic perspective rather than from an operational issue. In today's competitive environment, the company with the best supply chain in terms of cost and quality is likely to grow. A Lot of funding is needed for the development of supply chains. In India till date, the supply chain environment is not very developed lack of cold storage, poor transportation, poor condition of roads, a low level of warehousing facilities these are some problems organized retailing is facing today. Food retailing is the worst victim of supply-chain constraint. Profit margin in food retailing is much lower compared to other retailing. Wastage in the handling of food material aggravates the problem of low profit margin. Food retailing and other perishable retailing is characterized by extensive wastage because of improper packaging, lack of temperature controlled vans and manual handling. Intermediaries used in retailing are highly monopolistic, that results in higher price for consumers and equally thinner profit margin for the retailers. These monopolistic intermediaries make supply chain inefficient. Although, retailers' are trying to make their supply chain efficient, but lack of funding and several policy and regulatory issues are posing difficulties for retailers.

3.5.4 Labor employment problems

Organized retailing is a 24 hours, 7 days business. In most of the states operating a business establishment for 24-7 is not allowed. The retailers have to take special clearance order for its functions. The sector has acute employee shortage and employee retention is a problem as turn over is very high. There is an ample growth prospect of this sector, which in the future will generate several opportunities. However, much restricted India labor rules and regulation is making this labor shortage even severe. At this point, there is a huge crisis for talented and experienced professional in the retailing sector.

Many institutes have now introduced specialized post graduate degrees in retail management. These initiatives will help the sector to overcome its employee shortage to some extent. On a sectoral basis the demand for trained professionals in the area of apparel retailing will be highest, as a substantial portion of the market is organized.

3.5.5 High Cost of Real Estate

High real estate cost is a challenge for organized retailer. It becomes worse in metro cities which has high rents and acute place shortage. According to a report on retail finance “rent forms a large portion of the total expenditure (6 to 11 percent of the revenue) in retailer's income statement and can also turn a profitable store to a loss-making one.” The challenge for a retailer would be to find the right location so that it can attract maximum customers with the lowest rental burden. Real estate problems will become even more severe with time.

3.5.6 Private Labels

Companies manufacture products and customers buy brands. Manufacturers create national brands. Private labels are brands, created by a particular retailer. Brands created by manufacturers are available in all retail stores whereas private labels are only available in those particular retail store/stores that have their own private brands. Private labels are more profitable for retailers compared to the manufacturer's brands. As the middle man is cut out the private labels give better margins at the same time it helps the retailers to compete with manufacturers to increase their relative market share and their share of total profit. The concept is still new because the history of organized retailing in Indian is not very old. Few retailers have introduced private labels in the category of Food & Grocery, Apparels, Consumer Durables, etc., but the mentality of consumers are conservative when it comes to buying private brands. Though private labels may have a similar product, they will not be able to replicate the brand in all categories. The challenge lies in producing more and more successful private labels.

3.5.7 Unique Indian customer

The Indian consumer experiencing modern retail is not a very new concept anymore, but still reservations are there. As we have seen from the segmental penetration section that although food and grocery occupy a maximum proportion of the Indian retail market, but the share of organized retailing in this sector is really low. The slow growth can be attributed to the fact that till this date Indians prefer to buy fresh fruits and vegetables in small quantity over frozen or packed food. The preference for freshly cooked food comes from the Indian culture and family structure where women are still expected to cook and feed the family. Poor electricity and lack of refrigerators also makes freshly cooked food a better option over canned and frozen food. But the most important reason is the presence of several small stores from where people can buy easily in small quantities.

Since the liberalization of the Indian economy in the 1990s, consumer behavior has changed. The Indian retail market is very different from any retail market around the world. The market is fragmented, complex and dissimilar. A closer look of Indian demography would reveal that the complex retail market consists of several states with different cultural districts existing concurrently in a market. Unlike west food habits and buying habits are very different in India and vary drastically from state to state. Even neighboring states are very different when it comes to food culture. Thus the planning for a proper merchandise mix for Indian retailer is a challenge. To cater to the needs of different customers with differ buying habits is probably the biggest challenge organized retailers those who have stores across India is currently facing. Till date most of the organized retailers have a centralized purchasing system following Wal-Mart. The problem with this kind of purchasing is those who buy from one location at one point of time lack the knowledge of what is the real demand for products in different parts of India with different demographic and cultural background.

It is important for a retailer to understand the retail business environment which gives an idea of the dynamics of the business, competition, changing consumer mindset, innovation in technology, modern practices, legal and cultural issues, etc. These factors are the key drivers in the strategy formulation and implication adopted in order to grow, sustain and build relationships with consumers and societies. It also helps to increase the profitability of the

business. A retailer has to thoroughly understand the business environment on a day-to-day basis to plan his business to keep up with the changing times.

3.6 Retailing and Stakeholders' Interest: Theoretical Considerations

The stakeholder model is an alternative to the shareholder model developed by Friedman (1970) and others. According to Freeman, (1983) a stakeholder group is “any group who can affect or be affected by’ an organization.” Palgrave dictionary defines stakeholders as “those whose welfare is tied with a company” (Palgrave 1992). None of the definitions on stakeholders deals with the clause of legitimacy. Legitimacy becomes an important factor when one has to decide operationally which stakeholders’ claim holds more value.

More generally, these definitions make it unclear if activist groups or media can be considered as stakeholders or not. Based on the definition of Freeman anybody or any group having an effect on a business organization can be treated as stakeholders. Whysall (1998), Donaldson and Preston (1995) argue that “Certainly the media can and do affect retail businesses, but does that really make them stakeholders or should we, more realistically, treat them as an influence without a stake.”

The notion of competitors as stakeholders raises some debates. Ambler and Wilson (1995) suggested “there was a somewhat tautological argument if competitors are simultaneously and reciprocally stakeholders in each other. However, there remain several instances where it can be argued that competitors have genuine stakes in each others’ businesses, such as by raising generic awareness of products (e.g. mobile phone shops promoting a new technology), maintaining industry standards (as through trade associations) or general advertising to generate increased demand across a sector.”

Notwithstanding its critics (e.g. Ambler and Wilson, 1995; Argenti, 1997; Boatright, 1994), the stakeholder concept has found widespread and enthusiastic application across a range of subjects. For some, it offers the most promising basis for a normatively acceptable model of the corporation, as well as having descriptive, instrumental and managerial capabilities (Donaldson

and Preston, 1995). Against such a background, it is not surprising that a review of ethical issues in retailing should postulate a stakeholder-type framework (Whysall, 1995).

However, there remain problems with such a conceptualization. We can ask, for example, if each group is of equal standing and importance, and perhaps impose some internal structuring of stakeholder groups. Even without challenging the fundamental premises of stakeholder rights, problems still remain. Is the concept of stake holding conceptually manageable? “Stakeholders are defined as being those persons or groups that have, or claim, ownership, rights, or interests in a corporation and its activities, past, present or future which are the result of transactions with, or actions taken by, the corporation, and may be legal or moral, individual or collective” (Clarkson, 1995, p. 106). If the definition given by Clarkson on stakeholders holds true then arguably we are all stakeholders in all significant enterprises on a planet facing global environmental problems, where globalization increasingly typifies economic systems.

The roles of an individual as a stakeholder are multiple. An individual can be a stakeholder as a customer of some company, at the same time he can be an investor or employee in some other company. In the case of a proposed relocation of a store, does the individual play separate roles in each constituency, or perhaps more realistically engage in an internalized resolution of conflicting interests before canvassing support for a preferred solution across all that individual’s spheres of influence? It may well be that there is a danger of over simplification in portrayals, but as a framework for depicting ethical relationships between retailers, there is still value here. Moreover, the notion of the retailer as stakeholder-manager, having to balance the conflicting claims of various groups, is also useful when considering how companies address problems encountered in the harsh climate of competitive retailing. It should not be overlooked, though, that this is not the dominant perspective for viewing retailing, either by academics or practitioners. The marketing paradigm, with its emphasis on meeting customer needs, has generally prevailed (e.g. McGoldrick, 1990; Cook and Walters, 1991). Waddock and Graves (1997) depict corporate social performance as being fundamentally concerned with relationships between a firm and its stakeholders, arguing that firms that treat their key stakeholders well will be perceived as being well managed, and conversely so too. The case studied in the next section concern that converse situations, being an example of companies

that seem to have treated their key stakeholders less than satisfactorily and thus appear to have been mismanaged from a stakeholder perspective.

The Clarkson Centre for Business Ethics, based at the University of Toronto, has produced a 'Consensus Statement' which can be taken to represent current 'best practice' in terms of stakeholder theory. In summary, the statement contends:

1. "The purpose of the business corporation is to create wealth.
2. Individuals and groups participating – intentionally or consequentially – in that wealth-creation process are stakeholders.
3. Stakeholders contribute inputs, incur costs, and experience inconvenience and harm.
4. They have something at risk.
5. Stakeholder management aims to achieve an efficient combination of contributions, risks and benefits that takes account of the roles and concerns of all stakeholders.
6. Unbalanced pursuit of benefits for any one group, and attempts to obtain contributions from any group without balancing benefits, are incompatible with sustainable wealth-creation over the long term."

Based on the above- stated criteria, the groups identified below represent the main groups who might be considered as stakeholders in a retail business. They are the customers, suppliers, competitors, the financial community, the service provider, employees and landlords or property owners.

CHAPTER-4:THE CASE OF SUBHIKSHA

4.1 Subhiksha Background

Subhiksha was founded in 1997 by R. Subramanian, an IIT- and IIM- alumnus. The word “Subhiksha” is derived from the Sanskrit word, “Subhiksham” which means "giver of all things good." Subhiksha opened its first store in 1997. In a span of 10 years the number of Subhiksha stores jumped from 1 to over 1000. It sold Fast moving consumer goods (FMCG), pharmaceutical products, grocery items, mobile phones, phone accessories, and fruits and vegetables (F & V). It was the largest supermarket and mobile retail chain in India, which had presence in 90 cities.

Subhiksha opened its first store in, March 1997. The first store was opened at Thiruvannamipoor in Chennai with an investment of Rs. 4-5 lacs. In the first year, Subhiksha opened 10 stores in Chennai. By 2000 it had expanded to 50 stores in Chennai. In the next two years, it expanded to every part of Tamil Nadu. By the end of 1999 it had 120-130 stores across Tamil Nadu. Until 2004, it focused on consolidation in Tamil Nadu. Subhiksha then expanded to every part of India which could be a potential retail market. In the year 2004-2005, it decided to open 420 stores in Gujarat, Delhi, Andhra Pradesh, and Karnataka by 2006. In its supermarket, Subhiksha started offering fruits and vegetables; the logic being that since F&V are bought more frequently by customers, sharing the same would increase footfalls to Subhiksha stores. During 2005 looking at the tremendous growth in mobile business, Subhiksha started selling mobile telephones at its stores. It tried to ensure that it provided the highest possible value to customers by offering the deepest possible discounts.

In 2008, a typical Subhiksha store had pharmacy and telecom store operations, where pharmacy and telecom operated as sub-stores within the store. The pharmacy business operated by Subhiksha was focused on customers who were on continuous therapies like cardiac, diabetic, etc. They had regular consumption patterns and incurred significantly large medical expenses. The pharmacy maintained a list of customers and tracked their buying. Usually either the customers informed Subhiksha before they ran out of stock or Subhiksha checked with them

periodically because it knew their consumption patterns. As a result, it practically functioned with very little stock and was based on regular customer requirement; it bought the required medicine from drug wholesalers and passed on a standard discount of 10% to its customers. Most of the customers were aged people and the 10% discount translated to huge savings for the customers. Subhiksha saw pharmacy business as community service. The pharmacy store was managed by two people (to take care of two shifts).

In the telecom business, Subhiksha offered mobile handsets, charge cards and accessories. Subhiksha used to keep handsets of all leading brands from leading brands. As the number of stock keeping units (SKUs) offered were less than 100, managing store operations for the telecom business was relatively simpler than the supermarket business. The telecom store was managed by two people (to take care of two shifts).

4.2 Managing Supermarket Operations

4.2.1 Category Management

The supermarket kept around 1,200 SKUs that could take care of approximately 90% of the customers' value requirements. Typically, the store would stock only products of the top three brands in each product category (sunflower oil, detergent powder, etc.) This conscious choice allowed the store to manage its operations at much lower inventories which in turn allowed it to offer 8% to 10% discounts to its customers. In general, the SKUs moved fast and generated consistent and considerable volumes. Since the store stocked only 1,200 SKUs in the supermarket, it monitored its assortment very carefully so that it really captured on an average 90% of the value requirements of the customers. One senior manager of Subhiksha commented: "When we started a new store we made lot of effort to understand the requirement of target customers in the catchment area. Usually by end of six months we had good idea about the ideal assortment for the store. If customer finds that we can provide only 50% to 60% of his requirement he may not visit us again. For 10% of his requirement which is not served by the store he does not mind visiting other stores in neighborhood."

In FMCG (Fast Moving Consumer Goods), 950 branded merchandise and private label SKUs were stocked while in grocery 150 branded and private label SKUs were sold. From a consumer perspective, brands reduced the uncertainty while choosing products and also gave a guarantee of quality. As a result, consumers in general liked them. Private labels provided Subhiksha control over the design and quality of its products. Tatwa, Aaharam, and Subhiksha are some examples of private labels kept in the outlet.

4.2.2 Marketing

“Everyday low pricing” was always followed at the store. In the supermarket, it usually offered an average discount of 8%-10% on all the products irrespective of the quantity purchased with reference to the MRP (Maximum Retail Price). The discounts did not change frequently. Kirana stores sold their products at the MRP. The display at each SKU showed both the MRP and the Subhiksha store price so that consumers could compare prices while shopping. Also, the customer bill showed the total discount received so that consumers could estimate their savings. Outlets could not vary the prices; instead the regional unit set the price list for the stores. Given that the terms of trade with all the FMCG companies were fixed centrally, it was mainly grocery items where there was great flexibility in pricing at the region level. But within a region, prices were identical across all the stores in that region. The highest sales occurred in the first 10 days of every month. The store always offered some promotional schemes in that period to increase the footfalls. One of the promotional schemes was: purchases above Rs. 500, Rs. 750, and Rs. 1,000, get Rs. 25, Rs. 50, and Rs. 75 off, respectively. Sometimes, gift-based promotional schemes were offered.

Subhiksha periodically advertised through the local radio channel. It did not advertise through local newspapers and catalog mailings. TV advertisements were minimal for the supermarket. Whenever Subhiksha started operations in any city it brought out newspaper and local TV advertisements to create awareness. But, subsequently, it mainly depended on word-of-mouth as a primary medium of reaching people within the catchment area. So, unlike other organized retail players, the advertisement spend by Subhiksha was relatively at a lower level.

4.2.3 The Crew

The store was open between 9 a.m. and 10 p.m. and operated by 13 people (scheduled in two shifts). Two cashiers, two customer sales representatives (CSRs), and two sales assistants were present in each shift. Some employees worked in a split shift (morning and evening slots). A person was assigned for home delivery. Cashiers handled billing and payment transactions. CSRs were mainly responsible for store cleaning and hygiene, merchandising, and stock arrangements. They also assisted customers when the sales assistants were busy. Sales assistants mainly interacted with customers and assisted them in the shopping process. During peak periods, the main focus was on sales and checkout counters, while during lean periods, the focus shifted to cleanliness, inventory check-up, share arrangements, etc. During the first 10 days, almost all the staff members were present in the store and avoided taking leave. An assistant ROM (retail outlet manager) in addition to a ROM managed the store in two shifts. Most of the staff members were young women and new to the retail business. Continuous on-job training was provided to them. Cashier was the most “sought after” position among the staff members were motivated and promoted to this position based on their performance. Also, from a monetary perspective, if the store achieved its sales target, all the staff members in the shop were rewarded with coupons, using which they could buy material from the stores. The staff members were trained at the cashier counter during the lean periods. The Staff requirement at the cashier counter depended upon the business volume. The trained staff helped at the cashier counter during the peak periods. There were two checkout counters for FMCG and grocery units and 1 checkout counter for F & V unit. During lean periods, the FMCG and grocery units and the F & V unit had a cashier each who would perform all the operations, billing, weighing, and packaging items. F & V within the supermarket had its own billing counter in addition to two counters allocated for FMCG and grocery products. During peak periods, as the number of customers increased, shopping baskets increased, queues at the checkout counter increased, and more staff members were shifted to the three counters. Attrition was one of the main problems faced by the store. It affected the performance of the store. At checkout counters, it took time for new cashiers to pick up speed. The store staff personally knew most of the regular customers and their requirements. ROM tried to mitigate a problem if it was a small salary or relocation issue.

4.2.4 Management

The responsibilities of the managers included managing category-wise sales, increasing customer interactions (the business volume on a daily basis), maintaining store hygiene, managing personal, F & V wastage, and adhering to a planogram (drawing of a store's layout) and was evaluated based on the same. As the investment in terms of the inventory and the operating cost in terms of rental, wages and electricity and security were governed centrally, ROM could increase profitability of the store mainly by increasing category-wise sales and reducing F&V wastages and shrinkage. The Indiranagar (Bagalore) supermarket would have a fixed cost of Rs. 1.2 lacs per month including the rental (Rs. 40,000), wages (Rs. 60,000), electricity (Rs. 10,000), and security costs (Rs. 1,000). A typical store would have Rs. 6 lacs worth products in its supermarket inventory. For discount stores, their gross margins were much lower compared to other retail players; so generating high sales per store was very important. The organization had a SBU (strategic business unit) structure where each SBU in the region was responsible for operations, which included the stores in the region and the warehouse. The ROM reported to the business development manager (BDM). For a cluster of 6-7 stores, there was one BDM who in turn reported to the Vice President (VP). The BDM monitored the store on category-wise sales and F&V wastage and would visit competitor stores in the region. The VP would visit every store once in 10 days. Sourcing was a centralized function. For local sourcing of F & V and for a few local brands, a few sourcing people would operate from the region but they reported to the centralized sourcing. This allowed Subhiksha to take advantage of the economies of scale. For example, with each major FMCG company, it negotiated its annual terms of trade where because of the sheer scale of operations it could get significant discounts. Central sourcing allowed them to develop in-depth understanding of sourcing food grains and F & V across the country.

4.2.5 Customer Service

Initially Subhiksha provided a no-touch way of purchase for its consumers. This method proved effective in the initial stages. But as it grew, to attract more customers, Subhiksha adopted a

DIY (Do It Yourself) format in which customers could touch, feel and select the product they want.

Industrial engineering techniques were used to standardize and reduce the time required to process a bill. Bar code technology was used for branded FMCG and grocery products. Private labels provided the product and pricing information. In F & V, some SKUs such as onions were pre-packed in the bags. The goal was to speed up the checkout process and to reduce paperwork. Subhiksha had a fixed internal target that once the customer selected the items in the supermarket, the customer should be able to leave the Subhiksha premises in five minutes. This posed a challenge on peak days when a large number of customers visited the store and were also likely to have a large number of items in their shopping list. In Chennai and a few other locations, Subhiksha had put in place a two-stage checkout process where billing was done at stage 1, while the payment was received at stage 2. This was the outcome of a detailed time and motion study carried out by Subhiksha. A customer could place an order over the phone. The store staff would take the customer order and inform the customer about the expected delivery time. The order was packed and billed in the store and kept in the storage area. Also, the customer could shop in the store and ask for home delivery if the basket was large. A person (allotted for home delivery) delivered the order to the customer in an auto rickshaw. Around 15% of the business was through the home delivery channel. Billing for such orders was done when there was a low load at checkout counters. The store expected a minimum shopping basket of Rs. 1000 for home delivery. Some of the home delivery customers were located at a distance of 2-3 km. The store transport cost for home delivery worked out to be 1% to 1.5% of home delivery sales value. Although the main catch of the store were households located at a 1 to 1.5 km distance, home delivery was extended to households which were located at a distance of 2 to 3 km.

4.2.6 Logistics and Supply Chain Management

In the supermarket, the SKUs were divided into A to K classes in the descending order of the sales value/period (demand/period times price/unit). Greater attention was paid to the A to D category, each category having 100 to 125 SKUs, which accounted for around 80% of total

sales. A-class SKUs were reviewed on a daily basis while B, C, and D class SKUs were reviewed twice a week. The remaining SKUs (classified as E and K classes) were reviewed twice a month. Subhiksha believed in the philosophy that if there is excess inventory in the system, it should be kept in the store rather than in the warehouse subject to availability of storage space. So if there was excess stock, it was kept in the hub store because lead-time of supply from the hub store to another store was half a day compared to two days from the warehouse.

On an average, the store inventory was around six lacs. Inventory levels were very tightly controlled at the store. Losses owing to pilferage or breakages known as “shrinkage ratio” in Indian retail is around 1.5 % of total sales and eroded the bottom line. Because of the small size of the store, the shopping process could be closely monitored. Also, while unloading the goods (shipped by the warehouse) from the locked vehicle, the store manager and an external security person were present. The manager thoroughly checked the quantity shipped with the dispatch list sent by the warehouse with the security person. The unloaded stock was then kept in the storage area. Ten percent of the space was allocated for storage. Also, the store carried out the audit of the store inventory every month. Training was provided to the staff regarding the handling methods for different kinds of goods. Shrinkage costs at Subhiksha were 0.25 % of total sales. F & V had its own challenges. In the past, it was difficult to ensure that F & V would reach early in the morning. Later, the delivery schedule was such that they reached the store before 7.30 am. Unlike other products, some of the F&V SKUs required special handling because of the fragile nature of the products. Further, it was necessary to keep them shuffling to ensure that the offering looked fresh. Subhiksha’s biggest challenge was to maintain its supply chain.

E&Y’s official Mr. Mishra during an interview pointed out that, “A store has to deliver on time and in the right quantity, otherwise it will lose customers. As it is, the customer base for a neighbourhood store is a highly loyal one and it is difficult to wean away customers from the local kiranas.” Subramanian admitted this had been an issue. Subhiksha tried to implement SAP enterprise software systems to handle its supply chain management, but before it could implement it properly the chain ran out of cash and stopped all its operations.

4.3 The Warehouse operation

4.3.1 Hoskote warehouse: An example

The Hoskote warehouse was located close to the Hoskote town which was near Bangalore (25 km). It was connected to Bangalore via a national highway (Old Madras Road). The warehouse served Bangalore (55 stores) and Mysore (4 stores). Firms such as Amway and ITC had set up their warehouses in the neighborhood and the warehouse enjoyed the synergies associated with the “warehouse atmosphere”. For example, obtaining good internet connectivity at a comparatively lower cost was because of the existing infrastructure.

The total area of the warehouse was 66,000, square feet. The store had the capacity to serve around 80 stores. Each warehouse was built to cater the need to serve around 80-90 stores. Around 200 people worked in the warehouse. The warehouse did not have any fancy fittings, flooring, and air-conditioning unit. It operated on a lease contract for 15 years (which was renewable) and open 24 hours a day (backend). The average business volume per year was Rs. 80 crore with Rs. 1-crore investment in the inventory at the warehouse. The total cost of managing the warehouse was Rs. 2.4 crore/year. Transport costs were significant (Rs. 1 crore/year), while the rental cost was not high (Rs. 25 lacs). Security was managed by an external agency. The warehouse was divided into different parts according to the storage and operations performed. Each SBU had its own storage locations. Further, there were separate areas for segregation and batch making, private label processing, and loading and unloading operations. A small section of the warehouse was allocated for the office. Products were assigned to the bins based on the similarity. For example, the entire “cleaning” related products were assigned to the same bin.

4.3.2 Operations

Indents raised by the manual indenting module were electronically dispatched to the warehouse in the late evening. The following day, both the total and store-wise requirements for each SKU (FMCG and grocery products except rice and wheat) the list was given to segregation and batch-making unit. If a SKU was not available in sufficient quantities, the demand was met in

the order of A-B-C stores such that each store obtained at least five units. The store classification had been done based on the sales performance. The boxes were packed and sealed and then shifted to the area allocated for the corresponding store in its belt. A small sheet which displayed the name of the store was stapled to each box. The SKUs were ready for dispatch to the store in the late evening and the same were dispatched to the store in the afternoon of the next day. Loading, unloading, internal product movements, sorting, and batch-making operations were manual in nature. Subiksha had problems with its warehouse operations in Mumbai. Subhiksha had three big warehouses in Maharashtra. The warehouses were located in Pune, Mumbai and Nagpur. In addition to those big warehouses it had eight min warehouses in Mumbai. Subhiksha had around 125 stores located in Mumbai while in Maharashtra, it had around 210 stores. In October 2008 the Maharashtra Food and Drug Administration (FDA) suspended the license of Subhiksha Trading Services. It was the warehousing subsidiary of Subhiksha. FDA stated that Subhiksha Trading Services was not following the packaging norms. Apart from that it was found samples were adulterated. At the same time Bombay High Court summoned a suspension order on Subhiksha itself as it was not maintaining health and hygiene standards in its Bhiwandi warehouse which was in Mumbai.

4.3.3 Transportation Management

The F & V SKUs were dispatched to the stores in the early morning (6 a.m.). The truck returned to the warehouse at 11 am. About 14 vehicles were used for transport. In the afternoon at 1 pm, FMCG and grocery boxes waiting in the belt area were dispatched to the stores. A few additional vehicles were needed for FMCG dispatch. A typical vehicle served the demand of 3 to 4 stores (called as the belt). The belt area layout, loading, and unloading processes were sequenced to increase speed and reduce interference and hence reduce the damage possibilities. First unload, last load rule was followed. Stores were combined into belts so that vehicular transportation was reduced. The transportation was managed by a third party that could provide additional vehicles at short notice. Transport agreement consisted of minimum commitment plus additional rupees/km clause. Vehicle shutters were locked before it left the warehouse and opened when it reached the store unloading area in front of a security person and ROM. The keys were not with the transport agency.

4.3.4 Grocery Processing

The warehouse purchased some grocery as raw material (for example, rice from the mills) and processed it to produce private label products. Some private label processes were manual while some operations were done using machines. For example, a worker filled lentils in a private label bag and then sealed it after weighing it. Raw materials were checked for quality at the warehouse as per the standards that had been set to measure the quality. For example, rice cooking time should be 5 minutes on a medium flame. Also, some samples were sent to Chennai for quality checks. These finished products were kept in private label bins. Bar code technology was not used for private labels, instead the price and the product information were printed on the bag at the warehouse. As grocery items were procured in bulk, it contributed to some amount of inventory.

4.3.5 Supply Management

Around 40 suppliers (10 are major) supplied to the warehouse as per supply norms. For example, Hindustan Lever Limited supplied every day. Most of the suppliers supplied the products from their depots in Karnataka. As a result, the warehouse did not incur sales tax. Some suppliers expected a minimum order quantity. Nestle supplied once in a week (from Chennai depot) to manage the transportation costs. An average supplier lead time varied between 1 and 5 days. Fill rate was a major problem that affected the warehouse operations.

4.3.6 Mobile Retail Logistics Management

The warehouse did not stock mobile products and instead acted as a cross-docking point. Five hubs were set up in Bangalore to store the products and to feed different regions of the city. The hubs raised indents and the suppliers delivered the products to the warehouse where the receipts were recorded. The products were segregated as per hub requirements and immediately delivered to the hubs. Hubs delivered the products to the stores mainly using motorcycles. Because the hubs were located in the city, transportation time and cost to the store was small.

4.3.7 Human Resource Management

Workers were supplied by a contractor based in Delhi who could supply additional workers at a short notice. There was a lot of uncertainty in the truck arrivals. Most of the workers were not familiar with retail business. Training was provided to them on a continuous basis to increase their understanding of warehouse processes. Some important training areas included product handling methods, batch making and segregation process information, and product quality check methods.

4.3.8 Inventory Management

According to the Subhiksha philosophy, a warehouse should operate as a cross-docking point and should not keep much inventory. Its warehouse inventory for mobiles and F & V products lines was close to zero. In grocery, as it bought materials in bulk and also had some processing lead-time, it maintained some amount of inventory. Given that the service levels offered by FMCG suppliers were not at a desirable level, the warehouse ended up maintaining some amount of stock for FMCG products. Within FMCG products, it maintained shares for A to D category of items. For other categories, it acted as a cross-docking point. The total inventory in a region (inventories at the stores within a region and the warehouse) was very tightly controlled. There was a hard limit within which the region was supposed to operate. Category-wise inventory levels were monitored by RS himself.

4.4 Business Strategy

Providing 'Value for Money' was the strategy of the once renowned Indian discount retailer Subhiksh. Launched as a discount store in 1997, Subhiksha was an instant success. Subhiksha expanded quickly to other geographical areas in India through establishing chain of outlets in major towns in north and south India. Like most of the retailers Subhiksha too targeted the middle class Indians. As shown in the previous chapter (history of organized retail) post 1990s saw the growth in Indian retail. The major reason was liberalization. Post liberalization per capita income and disposable income of the Indian middle class increased. Naturally they

became the target consumer for all retailers. With its unique hybrid model, Subhiksha had all the processes and systems of a modern organized retailer. At the same time, it also maintained a neighborhood-convenience element, which immediately connected it to the middle class. The small format that Subhiksha adopted was also a planned move. When major players were trying to enter hypermarkets and malls, Subhiksha took a stand-alone-store format. Subhiksha stores were never located on the main roads, instead they were found in the nearby streets of a residential area. With this choice of location, the company could save money from the real estate costs. Subhiksha never opted for a fancy atmosphere inside the stores. To cut costs, at places, it opted for the first floor. With each store extending over a small area of 1500–2000 sq. ft., Subhiksha maintained a simple interior with no glamour elements in it, initially. But retail analysts were not very confident with Subikshas’s store format. Whereas most other organize retailer were following a mixed structure of both small and big stores Subiksha had maintained only small structures. Unlike other retailers the expenses on rent was comparatively low for Subhiksha. The reason Subhiksha chose not to open its stores on the main road was to save on rents, as rents on the main roads were very high. The strategic location of stores helped Subhiksha to slash down its rentals. Also, the stores weren’t air-conditioned, which reduced electricity costs substantially.

The advantage of Subhiksha over its competitors was the prices. The retailer used to give a discount of 9%–10% in the Maximum Retail Price (MRP) of every single product it sold. Indian customers are very price sensitive, thus this 9%-10% discount resulted in savings for the customer. This unique strategy of Subhiksha helped in attracting customers and increasing sales. This strategy was also the secret of Subhiksha’s success. The growth of the chain was phenomenal and soon Subhiksha became a household name among the middle class Indians with its punch lines like “Morcha” Against “Kharcha” (Fight against Expenses), “Bachat Mera Adhikar, Subhiksha Mera Abhiman” (Saving is My Right, Subhiksha is My Pride). Through strategically positioning itself as a provider of ‘value for money’ and through no-frills discount retail, Subhiksha successfully created an image of low cost, high quality neighborhood store. The idea of giving customers maximum possible discount without compromising on quality was well received by the customers. Following this Subhiksha became a trustworthy, dependable, value for money retailer. Subhiksha’s foray into drug retailing proved to be very

attractive, as drug retailing offered better profit margin. Subhiksha started giving discount on medicines too. This made the general medicine store operates team up against Subhiksha. Subhiksha's trade was affecting their sales. Subhiksha had to go to the court to continue sales of medicines at a lower rate. Subhiksha won and continued drug retailing. The retailer used to provide home delivery service for drugs. Drug stores usually have margins of 17%–20%, but Subhiksha sold drugs for a mere 7% margin. Even at this rate, the percentage margins in drug retailing were double that of grocery and more than 10 times that of fruits.

The problem with Subhiksha's strategy of low cost high quality products was, if it had to pass on huge discounts to customers it was very necessary for the retailer to keep its cost to the lowest possible limit, but Subhiksha failed to do that.

Subhiksha started as a grocery retailer, as research revealed that groceries accounted for highest share in the expenditure of an average Indian customer. In rural and semi-urban areas, food and groceries form more than 50% of the total consumer income, in urban areas the share is around 30%. However, as disposable incomes are higher in urban areas, amount spend on groceries in absolute numbers are much higher. Subhiksha tried to build its image as a discount store by offering huge discounts. But at the same time it tried to follow the ambiance of local kirana stores. The FMCG (Fast Moving Consumer Goods) business in India was valued \$15 billion or Rs 75,000 crore annually, by PricewaterhouseCoopers in 2006-07. The total revenues of organized retail, consisting of all formats and all the goods, in their entirety were around the same size. About 90% FMCG sales occurred through the kirana stores, while the retail chains accounted for about \$1.5 billion or Rs 7,500 crore. Subhiksha saw a grand opportunity in this area and entered into groceries. Subhiksha afterwards started selling grocery, mobilies, medicines, fruits and vegetables.

After making a mark in the grocery division, Subhiksha wanted to enter the consumer durable market. Subhiksha planned to diversify its business by June 2009. The plan was to invest around 600 crore in the consumer durable section, by setting up 150 specialized stores across the country and make the brand name Subhiksh even bigger. The idea was to set up consumer durable stores mostly in metros, Tier I and II cities. 65 cities were identified, where Subhiksha

was planning to open its consumer durable stores. But the company failed to diversify in this business, as it had to stop its operations by early 2009.

The number of Subhiksha stores shot up from one store in 1997 to a chain of 50 stores in Chennai by 2000. In the next 2 years, it opened around 130 stores across Tamil Nadu. After the company's initial success, it started to hire professionals from various companies for the top management positions. The plan of the company was to enter every possible retail market in India. In order to create a strong management to manage operations at different locations, it started appointing experienced people from different industries. The idea of hiring experienced profession was a strategic plan, but the problem was these people were from different industries and not from retail industry. The people Subhiksha hired were mainly from FMCG, banking and pharmaceutical industries. Even though the company hired experienced professionals from different industries for its top management position, Subramanian, remained the man behind the show. The low cost high quality strategy was planned and executed by Subramanian, which eventually became the most important strategy behind Subhiksha's success. The company used to source people for its store management and customer care services through a separate external agency while managerial hires were selected by the top management.

In order to maintain lower prices, Subhiksha concentrated on direct procurement avoiding intermediaries. During the initial periods, the chain managed procurement on a per-store basis; where in the manager of an individual store would replenish stocks at the end of every working day through cash. Through cash purchases and higher volumes, it succeeded in negotiating higher discounts, which were passed on to customers, but as the chain expanded it had established 14 central purchase centers across the country and goods were sent to all the stores. Supply chain management remained a concern for the Indian retailers and Subhiksha tried to utilize supply chain software. However, as it expanded, the inventory management and re-ordering did trouble Subhiksha. In 2007, Subhiksha initiated implementing SAP – most popular Enterprise Resource Planning (ERP) software in the world, but the process was not completed until the company ran into troubles. It also had plans to integrate all its stores through wireless communication in order to achieve operational efficiency, to help outlets plan and manage demand and supply of share on shelves. Also, 1 MBPS line was planed to be used to connect

both the front and backend operations. This would have also helped the company to acquire real-time information needed to ensure harmonization of the stores and the supply chain, but due to lack of funds, this too got shelved. Due to these failed attempts, managing the in-store inventory remained an issue for Subhiksha and many times, bare shelves put both the consumer and store management in an awkward situation. Lack of technology, which affected its supply chain and inventory management, haunted Subhiksha, but quick inventory turns improved the cash flows.

The huge quantity of purchase helped Subhiksha to cut costs by bargaining discounts. Initially, it resorted to cash purchases to avail maximum discounts. Once it became a major customer, FMCG companies increased credit lines to Subhiksha. As stated earlier private labels are more profitable for the retailers compared to manufacturers brands. Subhiksha tried to capitalize on that. In order to reduce cost Subhiksha started sourcing from contract manufacturers for a variety of products, including soaps, toothpaste and instant noodles. It also started selling private labels like Tatva, Bix and Zoop. To cut costs further, along with bagging discounts on national brands, Subhiksha aggressively promoted private labels for products ranging from wheat to shaving cream. And by 2004, around 25% of company sales came from private labels.

4.5 Expansion

Subhiksha's first store was opened in March 1997. Between March 1997 and March 1999 the company opened 19 stores in an around Chennai. The idea of a value for money discounted store was well received by the customers and Subhiksha started breaking even. Initially in its first year Subhiksha faced some problems from the unorganized retail traders of Chennai because of its unique low cost model, as it was undercutting their business. Subramanian managed the situation. By 2000 the number of Subhiksha stores in Chennai rose to 50. It was during this time Subramanian contacted ICICI-venture for financial help. I-Venture picked up a 10 per cent stake in Subhiksha for Rs 15 crore.

ICICI-Venture gave Subhiksha the identity, financial strength credibility and exposure. I-Venture's 15 crore was used by Subhiksha to open new stores outside Chennai, into different

pats of Tamil Nadu. By 2002-03, the retailer had 140 stores across Tamil Nadu. It managed to open stores in 30 cities and towns across Tamil Nadu. During this time sales and cash flow grew reasonably. From 2004 Subhiksha decided to expand nationally. It planned to scale up its operations and planned to enter cities and towns outside Tamil Nadu. Subhiksha started opening stores in two to three states simultaneously, instead of going by the rule of one state at a time. Between late 2004 and early 2007, on an average, 60 to 70 stores were added in a month. Equity worth Rs 160 was raised from I-venture. Apart from equity debt capital and bridge loans were used for opening new stores across India

“The pace of rollout is evident from the fact that till September 2006, Subhiksha had a store count of just 160, but by March 2007 it had shot up to 670 and by March 2008 to 1,320. By September 2008, it was 1,650-in all 1,500 stores were added in just 24 months. "Business was growing like mad. Despite the cost pressures in 2006 after Reliance, the Birlas and others announced plans to enter retail, between 2006-07 and 2007-08 we doubled our stores (from 670 to 1,320), tripled our revenues (from Rs 833 crore to Rs 2,305 crore) and almost quadrupled our profits (from Rs 11 crore to Rs 39 crore)," said Subramanian” (Business Today, June 28, 2009).

Wipro Chairman Azim Premji was impressed by the massive growth in number of stores of Subhiksha. In March 2008, Premji’s Zash Investments picked up a 10 per cent stake in Subhiksha for Rs 230 crore. This 10 % stake was sold to Premji by ICICI-venture. Afterwards this particular act of I-venture was criticized by Subhiksha’s MD Subramanian. After Subhiksha was dissolved Premji accused Subramanian for his losses and concealing the actual financial situation of the company from him.

After successfully establishing itself in TamilNadu, Subhiksha planned to capture every part of Indian retail market. It started opening up stores in practically every state of India. Initially after its inception it targeted South India but after a couple of years it started its national rollout. By the end of 2006, it had stores both in North and South India. After successfully establishing itself in every part of India Subhiksha managed to come out of the image of a ‘Chennai centered South Indian brand’ and became a national brand. Competitions and challenges were no less in these markets. Subhiksha’s unique format as a discount store worked in its favor. Subhiksha succeeded to gain the confidence of the customers, making it successful in most of

the markets. In 2007, it entered as a mobile phone retail chain in Kolkata and Kerala. Subhiksha made plans to expand during 2008. The extended product lines like mobiles and medicines too helped the retailer to earn popularity. With the growth in the number of stock keeping units (SKU), the chain moved to do it yourself format from no-touch format. With this change Subhiksha was competing with the likes of More, Reliance Fresh and other supermarkets. These supermarkets have had their outlets on the main roads, unlike Subhiksha's outlets in the interiors with limited parking space, eventually the chain was neither a discount supermarket nor a proper supermarket. This confused positioning affected the chain's sales to a great extent. Many were skeptical about Subhiksha's move to north India initially – partly due to doubts whether Subhiksha could meet the requirements of a population completely different in culture and perceptions and partly because managing logistics across the vast territory of India is so difficult a job that it wasn't attempted by any retail chain in the country before Subhiksha. Doubts were also raised on Subhiksha's financial strength to manage logistics on such grand scale.

4.6 Problem

Problems for Subhiksha started in October 2008, after it realized that it is out of cash and the working capital requirement was huge. Thus it started getting legal notices from suppliers, vendors, media etc., for outstanding payments. In January 2009, the retail chain was left with no other option but to stop its entire operation. At that point of time it had around 1600 stores all over India.

After it stopped all its operations in January 2009, Subhiksha approached the banks for more money. A total of 13 banks lent Subhiksha Rs.750 crore to restructure its debt. Subhiksha was the first retailer in India to go for a corporate debt restructuring (CDR) programme. As explained in the context of the study that in 2008-09 the Indian economy was experiencing a slowdown. Because of the slowdown India retail market was experiencing falling demands and most of the retailers were having problems. But it is worth noting here that apart from Subhiksha other retailers survived the slowdown. It makes us question what role did the management of Subhiksha played. Subramanian explained to the banks that falling demand and

the slowdown were the main reasons for Subhiksha unable to pay its original payment schedule and it went for CDR. However, there was no progress. The CDR, which was supposed to be completed by July 31, 2009, never materialized. A senior public sector bank official said the case did not meet the norms for a debt recast. So, it went out of the CDR system, leaving each bank to decide what to do with its bad loan. In August 2009, Cash and Carry Wholesale Traders Private Ltd (C&C) filed an agreement proposal for a merger of Subhiksha with its subsidiary Cash and Carry Wholesale Traders Pvt.Ltd. According to the proposal of C&C “the secured creditors of Subhiksha had to settle for 50 per cent of the principal taken from October 2008. For the unsecured lenders, the company would start repaying the principal amount between January and December 2011” (Business Standard, August 6, 2009). Creditors, including ICICI Venturs, DCB bank, ICICI bank, Kotak Mahindra and Zash Investments, did not agree to the merger proposal. Instead, Kotak Mahindra Bank filed a petition with the court under the provisions of Company's Act 1956 seeking winding up of Subhiksha, as the retailer failed to pay Rs 35 crore taken from the bank as part of the CDR. The creditors questioned the actual motive behind the merger, which according to them was not in the public interest. The creditors complained that a certain amount of secrecy is being maintained by not providing them the statutory information, including the application for the scheme which is raising doubts. Kotak Mahindra Bank further stated that it is important to investigate the conduct of the managing director of Subhiksha. The counsel of Kotak Mahindra Bank, Mr.Seshadri said that Mr.Subramanian (MD) has “wilfully” transferred money to several sister concerns of Subhiksha including C&C. He also stated that there were few other companies like Custodial Services India, Pentagon Trading Services, Shevaroy Holiday Resorts and Triad Trading Services which were set up and controlled by the MD of Subhiksh for tunneling money.

In October, 2010, the Madurai bench of Madras High Court dismissed the merger proposal of Subhiksha with its subsidiary Cash and Carry Wholesale Traders Pvt.Ltd. Justice V. Ramasubramanian of the Madras High Court reading the order stated that “The plan submitted by the petitioners makes it obvious that the proposed scheme is not financially viable, since it is structured on many ifs and buts and presumption on surmises. Therefore, the court cannot permit consciously, the transfusion of blood of several members of the public, to a patient who

has suffered multiple organ failure and various other ailments and whose chances of survival depend on miracles” (Business Standard, October, 2010)

The bench observed that the claims of Subhiksha that Rs.230 crore was transferred between Subhiksha Services Limited and Blue Green Constructions & Investments Limited were not transparent. The court said that how inventories of Subhiksha worth Rs.551 crore vanished is also unclear. Based on all these observations the Court felt that the merger proposal was not best for public interest. It also felt that the survival of the company was based on several presumptions including further money infusion does not look viable.

The merger proposal was dismissed on October, 2010. The winding up petition of Subhiksha filled by Kotak Mahindra bank in August, 2009 went from one court to another, including High Court, Company Court and Apex Court. Finally on 29th February 2012 the bench of Mr Justice Arumughaswamy of the Madras High Court ordered the winding up of Subhiksha Trading Services. The court also ordered the official liquidator to take over the assets of Subhiksha. The creditors were at liberty to file their claims. The court while reading out its decision stated that the company has failed to prove its contention that it suffered heavy losses due to the global financial crunch. It has not even whispered how it incurred losses to the tune of Rs 800 crore. The court ordered the Official Liquidator appointed by the Court to take over the assets of Subhiksha. All other petitioners were at liberty to file their claim petition before the Official Liquidator. Consequently, connected company applications were closed.

Below I have discussed some of the major reasons behind Subhiksha’s failure.

4.6.1 Recession, Capital structure and over expansion

Subhiksha’s failure was the result of recession, capital structure and over expansion. Subhiksha had financial troubles right from the beginning. Its first phase of expansion was during 2000 with the first round of funding of INR 15 crore from I-ventures. In 2004, it received the second round of funding, INR 25 crore. By 2006, the number of Subhiksha stores touched 1,000 mark. Analysts observed that, the expansion continued without sufficient capital back up as debt to equity ratio of the company was high. Depending on high level on debt cost Subhiksha its

dissolution. The equity base of the company was very low and it expanded mainly depending on debt, by taking loans from the banks. Subhiksha's expansion was basically from the fund infused by ICICI's capital arm, I-Ventures. In 2007, the company initiated INR 500 crore for phase II expansion to make a foray into Madhya Pradesh, Punjab, Haryana and West Bengal. During 2008 most of the big retailers were struggling to open new stores because of falling demands and financial crunch. Subhiksha surprisingly was opening stores every month. Subhiksha became the largest retail chain with 1,480 stores stretched out in 110 cities across the country. Subhiksha also had 125 outlets in Mumbai and 175 in Delhi. From September 2006 to September 2008, the status of stores changed from '150 across Tamil Nadu' to '1,650 across the country', and this largely contributed to the company's turnover. The turnover rose continuously from INR 330 crore in 2005–2006 to INR 2,305 crore in 2007–2008 a projected INR 4,000 crore in 2008–2009. Apart from opening retail outlets for mobiles, Subhiksha had planned to open stand-alone outlets for consumer durables too. With changes in the format (15,000 sq. ft. on an average and better ambience), but following the strategy of discount store Subramanian was sure that this mixed format will work. But the company was in the middle of financial crisis very shortly.

The expansion of Subhiksha was totally debt driven. Instead of working on its equity base and analyzing the negative consequences of low equity the company concentrated on increasing the number of stores. The recession struck the India economy by the end of 2008, when Subhiksha was in the middle of its huge expansion programme. Due to the negative effect of the slow down on the financial sector of India, external source of funds for Subhiksha stopped. The huge debt burden on Subhiksha due to its uncontrolled expansion on debt left the company with no other option but to shut down. Once the company ran dry of all cash, operation of Subhiksha across the country was stopped. Its financial woes were manifested by its failure to pay around 15,000 employees for over 6 months. As the discounter fell into trouble, it tried seeking help from major investors like Wipro's Azim Premji and ICICI's I-venture.

The retail chain was affected badly by the credit crunch. As the financial market was very difficult due to the credit crunch banks were in no mood to help Subhiksha by extending the credit lines. When all the attempts for gaining liquidity failed, the company had no way but to

stop its operations. “We were doing really well till we realized that we didn’t have any more cash...When we realized we needed more money the crisis got even worse and nobody was ready to help us out” said Subramanian (Business Standard, August, 2009). To add to the woes, most of the people of the executive board of Subhiksha left the company. According to the explanation given by the management of Subhiksha, the company was unable to pay the security agencies as a result the stores and warehouses of Subhiksha remained unprotected. Around 600 company stores across the country were ransacked. “The crux of the problems,” Subramanian said, “is that the company expanded too rapidly on a small equity base of INR 250 crore and grew the business, primarily through debt, to a level of 1,600 stores.”The enormous increase in the number of stores seems something more than it could take. The operations were highly scattered because of the expansion to various states. Moreover, the low equity also spelled trouble. Because of the over ambitious plans, the company landed in a debt of INR 7 billion (\$143million, €11million, £100million). In March 2009, the company had dues of INR 85 crore, with an interest expenditure of INR 9 crore per month; quite a huge amount in the troubled times.

Subramanian wanted to transfer Subhiksha from a private company to a public company. It was an attempt to improve the equity base of the company, but he failed twice to make the company public. The last option left for him, was to bring in more investors. Expansion might attract more investors, but the waves of financial distress were spreading fast, denying any respite for the chain. Subramanian chose to go for a reverse merger in order to make Subhiksha a public company. Subhiksha acquired a small but listed non-banking financial company named Blue Green Constructions and Investments. The company was Chennai based. The idea was to merge Subhiksha with Blue Green construction and rename the company as Subhiksha Limited. This would have enabled Subhiksha to automatically get listed and the public status it wanted. But Subhiksha’s main investor ICIC- Venture opposed to the reverse merger plan and thus, Subhiksha’s verdict was made.

4.6.2 Operational Deficiencies

Operational deficiencies were one of the main reasons for Subhiksha's crisis. The chain's supply chain management lacked required expertise and technology was too weak to support sophisticated retail operations. While modern retailers depend largely on advanced technology, Subhiksha operated on IT infrastructure that it possessed from the beginning. Even when it expanded, Subhiksha did not or could not upgrade its technological powers. The MD agreed with the fact that the supply side logistics was not good, since there was no up gradation of technology. But he justified it by saying, as the business was running on venture capital (ICICI Venture had bought a 33 per cent stake in March 2005 and sold off 10 per cent in 2008 to Premji's Invest for Rs 230 Crore), it was important for the company to cut costs and so it could not invest too much in technology.

4.6.3 Relation between I-Venture and R. Subramanian

In 1997 Subhiksha opened its first store in Chennai. From the time of its inception Subhiksha's founder and MD R. Subramanian had the objective of making Subhiksha a national brand. Soon after Subhiksha's first store was launched, Subramanian started to plan an aggressive growth strategy for his company. Following his aggressive growth strategy Subramanian opened 50 stores across Chennai between 1997 and 2000. Soon RS realized that if he wanted to make Subhiksha big, he will require more funds. RS then started looking for some external source of finance. RS was familiar with the brand name of ICICI Venture. Subramanian contacted I-Venture to explore the financing options. Subramanian realized that if he succeeded to associate Subhiksha with a brand name like ICICI Venture than it will be a great move for Subhiksha. Not only Subhiksha will have a secured finance coming, but at the same time this association will give the much needed exposure to Subhiksha. Initially I-Venture invested \$3 million in 2000. Eventually I-venture invested a total of \$20 million in Subhiksha in four rounds over seven years. ICICI Venture was Subhiksha's only external source of equity.

Over the years, by virtue of working together closely the relation between I-venture and Subhiksha changed from a purely functional one to a relationship based on mutual trust and respect. I-Venture gave Subhishka the credibility and identity it needed. With the finances of I-Venture Subhiksha managed to expand the company's geographic footprint. Apart from capital

Subhiksha got management support from I-Venture. Trouble started between the two in 2007, when in a bid to get listed RS decided to merge Subhiksha with Blue Green constructions. But I-Venture from the very beginning did not support Subhiksha's reverse merger plan. This is when the trouble started between the two.

Problems between the two became severe when in February 2009 the Employees Provident Fund Organisation (EPFO) sent notice to I-venture asking it to pay the due PF of Subhiksha's employees. EPFO said in the notice that Subhiksha failed to deposit provident fund dues for around 4,500 employees from June, 2008. The outstanding provident funds due was Rs. 5 crore. I-Venture refused to do it stating that it had no control over Subhiksha's operations. It also blamed Subhiksha for keeping the investors in dark.

But Subramanian insisted that I-Venture had every right to control the company according to the Articles of the company and it did so. RS said, according to the Articles of Subhiksha, ICICI Venture can appoint the majority on the Board, and in fact had appointed the majority on the board. Hence, not only control of board, but it also had extensive right on the operations, including right to appoint statutory auditor. And every right was exercised.

I-Venture strongly denied Subramanian's claim that it controlled the board of Subhiksha. I-Venture replied that it had a minority stake in the company. According to I-venture Subhiksha's MD Subramanian who is also the majority shareholder of the company was the one in the controlling position. I-Venture further clarified that the MD used to exercise complete control over the day-to-day functions of the company, including company's administrative and financial functions. Subhiksha Trading Services Ltd (STSL) accused its investor stating that the investors have benefitted a lot from the company when it was healthy. Now when the company needs their help they are not helping. Subhramaian without mentioning ICICI Venture directly accused that a certain investor wrongfully diverted equity ment for Subhiksha to itself. That act of the investor pushed Subhiksha to a serious financial risk. One can easily understand that the investor RS was pointing at was I-Venture. In 2008 I-venture sold 10 per cent stake in Subhiksha to PremjiInvest for a sum of Rs 230 crore.

Renuka Ramnath, Managing Director & CEO, ICICI Venture, replying to the accusations made by RS told that I-Venture was a minority shareholder in Subhiksha with no control rights. But as a responsible investor they were trying their level best to come up with a viable solution to rescue Subhiksha from its financial mess. They were constantly talking with other investors and stakeholders to come up with some solution which will be best for all the stakeholders, including the employees.

Subramanian said the position in law is clear, control vests with the ones who can appoint the majority of the Board — the board decides what the company and the MD would do and hence those who have the power to constitute the majority of the board have complete control of the company. He added that in such a situation even if he was the MD under articles, he cannot exercise any power as the board was dominated by and was legally in the control of ICICI Venture. According to Subramanian he did not control Subhiksha's board. His duty as a managing director was only to take care of the day -to-day operations of the company.

Citing SEBI takeover code Subramanian clarified that if a certain investor appoints majority of directors in the company then the said investor can be termed as the controlling investor. According to Subramanian ICICI Venture was in control of Subhiksha since 2004 by virtue of appointing or removing people in the senior levels. It also controlled the audit committee of Subhiksha by appointing statutory auditors.

The major internal problem regarding the controlling power between I-Venture and Subhiksha's MD Subramanian accelerated the downfall of Subhiksha. The case of Subhiksha had a certain fraudulent angle; no investor was ready to take any charges for the company's precarious condition. Thus the blame game continued.

4.6.4 Role of Management

Subhiksha had financial problems from September 2008. Due to its financial constraints Subhiksha started to close its stores one by one from October, 2008. In January 2009 the company came to a stand still after closing its all 1600 stores across India. Management of

Subhiksha claimed because of its financial troubles the company could not pay the security agencies. The stores and warehouses of the company remained unprotected. Employees of Subhiksha taking advantage of the situation looted inventories worth crores from stores and warehouses of the company. There was no money on Subhiksha's bank accounts. But it raised question as to how a company like Subhiksha, who in 2007 claimed sales of Rs.2,300 became totally cashless within a span of few months. Subhiksha realized its precarious financial position in late 2008. The company then tried to get external finances, but by then India was in a middle of financial downturn. The management of Subhiksha explained that the company was a victim of the situation. It was the economic slow down which ruined the company.

The relation between the major shareholders of Subhiksha during the crisis was telling a different story of Subhiksha's failure. The Registrar of Companies (Chennai) started looking into the books of Subhiksha after getting written request from Subhiksha's investor ICICI-Venture in 2009. ICICI-Venture wrote to the registrar of companies asking for an inquiry of the managerial and financial operations of Subhiksha starting from April 1, 2007. The investor also requested the registrar of companies to do an independent audit of the accounts of the company.

Subhiksha for the year ended March 31, 2007 had shown a turnover of Rs 839.56 crore and a profit before tax of Rs 18.36 crore. The inventories for the period were Rs 279.32 crore and secured loans of Rs 245 crore. ICICI Venture alleged that "Subhiksha through its presentations said that it was doing well and was aggressively pursuing a growth strategy which involved almost doubling the number of stores in two years from April 2007. It had said there were 1,300 stores at the end of March 2008 with a target to reach 2,200 stores by March 2009 and it had already crossed 1,620 stores by August 2008. The retailer also acquired a Chennai-based non-banking finance company (Blue Green constructions and Investments Limited) and planned to reverse merge Subhiksha with it in a bid to list and widen the investor base after the near collapse of the global and local share markets. But ICICI Venture was taken by surprise when Subramanian approached the company for Rs 50 crore liquidity support to stock up the stores, against pledge of shares" (Business Standard, February, 2009).

In October 2008, ICICI Venture started receiving legal notices from media, advertising companies, manufactures, vendors and suppliers. The notices were mostly related to outstanding payments. After receiving these legal notices the investor tried to figure out how is it possible for a company like Subhiksha apparently doing so well can have outstanding payments worth crores of rupees. I-Venture started a field inquiry on its own, which revealed that the inventories were much lower in reality compared to the information given by the MD of Subhiksha. In a board meeting held on November 22, 2008, the MD of Subhiksha for the first time confessed that the company is under deep financial pressure and admitted the seriousness of the problem. ICICI Venture accused that Subhiksha failed to present the 15-month audited accounts ending June 31, 2008, in the board meeting so the investment firm was skeptical of the company's financial stability and health. ICICI Ventures had also filed a complaint alleging diversion of funds through more than 100 shell companies. I-venture stated it had doubts that Subhiksha's funds were misappropriated and wanted a detailed inquiry, so it wrote to The Registrar of Companies seeking for a detailed investigation.

After The Registrar of Companies received investigation request by I-Venture and found that Subhiksha was not paying PF dues and salaries, the registrar of companies (Roc) started probing. Subhiksha, they found, was regularly breaking rules. The report also doubted the role played by the auditors of Subhiksha. Deloitte stopped auditing the accounts of Subhiksha after June 2007. But why Deloitte stopped auditing was not clear. The annual audit of 2007-2008 was done by a Chennai based local auditing firm. Although the MD gave the impression that in the latter half of 2008 Deloitte was reappointed, but on the board meeting which took place on 22nd November 2008 Deloitte revealed that they never received any appointment letter from Subhiksha. A Deloitte spokesperson said the firm was bound by confidentiality rules and that they had not done any audit as they had not received any financial statements after March 2007. The report questioned about the accountability and responsibility of the board of Subhiksha and the banks which lent money to Subhiksha without proper check. Either the board was ignorant or it just did not do its job when fraudulent activities were taking place.

Subhiksha was linked by the investigators to at least 42 shell companies which it suspects were used to route bank money. Another eight companies also appear to have been floated by

Subramanian. All the companies were linked to each other by common shareholders and all of them hold shares in other companies, forming a complex matrix making it difficult to unravel who is ultimately controlling which company. All these companies have common directors, common shareholder or share addresses. Investigators have reason to believe that Subramanian diverted bank funds to many of these shell companies and hid the fact by inflating Subhiksha's revenue, profits and inventory in order to give the impression of growth.

For instance, Stone N Sand Builders, Sun N Sand Tours and Shevaroy Holiday Resorts all had a share capital of 5 lakh, share premium of 5 lakh and investments of 5 lakh in each other. "It seems that no amount was received by any of these three companies towards share capital and share premium and no amount was paid by any of these three companies towards investments in these companies and possibly there may be only book entries, which is a very serious matter," the report says. It is felt that these examples are only tip of the iceberg. There was heavy manipulation in the accounts of the company. In another instance, the investigators found that, "City Capital Foundation, a company in which Subramanian has declared interest, was retaining all credit card sales collections of Subhiksha and depositing it with the company only towards the end of the month.....There is diversion of huge funds of the company each month from the month of October 2006 to March 2007 to City Capital Foundation.... Hence directors are working in a manner prejudicial to the interest of the company," the investigators wrote.

While most of the diversion seemed to have happened through circular banking transactions, other cases were more blatant. City Capital, for instance, was asked in April 2005 to set up all shops outside the state of Tamil Nadu. All capital expenditure was undertaken by it, but there is no record of any board resolution or approval given by the board. A director told that this matter was never discussed or brought to the notice of the board. The investigators also said Subramanian declared interest in 13 companies, but he maintained that they were not related parties, although Subhiksha used to buy most of its grocery items from these companies. Subramanian claimed he had secured an opinion from Justice VN Khare, former chief justice, that they were not related parties but copy of the legal opinion was not shared. Loans for more than Rs 600 crore were taken without a full discussion or approval from the board, raising the

question how banks allowed this to happen. It is astonishing as to how all these banks sanctioned such huge loans when the company had fixed assets of Rs 188.38 crore and inventories of Rs 363.92 crore only as per the audited balance sheet as of March 31, 2007 which was only available from September 2007.

The directors of Subhiksha gathered for a very important board meeting on November 22, 2008. A few weeks after, I-Venture's Ramnath had discovered something alarming in the accounts. The inventory position in July-September was Rs 660 crore, a huge figure for any retail company. Taken aback, she asked a team of I-Venture's investigators to inspect all Subhiksha warehouses for an independent survey. Subramanian protested loudly but was overruled. The survey team returned a few days later. The inventory, according to them, was not even worth Rs 50 crore. The board meet itself was stormy. Subramanian refused to consider it a formal one and Rama Bijapurkar chaired it. It lasted one full day and Subramanian was questioned in detail about the true financial position of the company. The questions were mainly about the discrepancies in the company's accounts and the amount of outstanding debts. Auditors from Deloitte were called in and they made the startling disclosure that they did not receive any appointment letter from Subhiksha. In the end, the board decided to take control: appoint KPMG to do a detailed audit, appoint a CFO and asked the company to finalize the accounts before December, 2008.

The chair person of the meeting Bijapurkar, afterwards revealed that the MD did not comply. Audited accounts for 2008 were not finalized and no CFO was appointed. KPMG was not allowed to do the audit. One by one, I-Venture's nominees resigned. For Ramnath, it was a bitter end to what promised to be a great investment. Its failure had as much to do with her and I-Venture's lack of oversight as with Subramanian's financial manoeuvring.

In April 2010 RoC submitted its report to the Ministry of Corporate Affairs. RoC made a litany of charges against Subhiksha: paper companies were set up to manipulate accounts and siphon money, transactions with related parties were not disclosed, and the board just did not do its job. After High Court dismissed the merger proposal of Subhiksha with Cash & Carry in October, 2010 Serious Fraud Investigation Office (SFIO) of The Ministry of Corporate Affairs

started looking into the case of Subhiksha. RoC in its report suggested that since it is a case of systematic, gigantic fraud SFIO should investigate.

4.7 Conclusion

The story of Subhiksha typifies the struggles of the Indian organized retail sector, which is caught in the whirlpool of bad decisions, confused formats, immature expansion, unjustifiable investments, excessive optimism and above all recession. It was over expanding at a time when there was financial turmoil going on, so it was quite natural that it failed to get extra credit from banks. Thus the expansion was ill-timed. Again on the other hand it failed to optimize on its own resources. If nothing else, the Subhiksha episode exposes the Indian regulatory and banking system's deep vulnerability. Whether it is private equity firms willing to glance the other way in return for a quick buck, accounting firms relying excessively on management-speak or banks desperate for business, promoters accused of violations always manage to stay ahead.

CHAPTER-6:THE CASE OF AIR INDIA

6.1 Introduction

The aviation department of Tata Sons Ltd. was established on July 1932. Under the Aviation Department of Tata Sons Ltd, which latter became Tata Airlines air services of India began in October 1932. In July 1946 Tata Airlines air services was renamed as Air India Ltd., and incorporated as Air India International Ltd., in March 1948. The company changed its name back to the original Air India on 8th June 1962.

6.2 History of Air India and Indian Airlines

On February 1938 Government made a contract with Tata Airlines. On 29th July 1956 Tata Airlines name was changed to Air India and it was converted into a public company and it was managed by J.R.D Tata. The company became a state corporation on 1st August 1953.

The Central Legislature brought into force the Air Corporation Act 1953 w.e.f. 28.5.1953. The Preamble of the Act mentions the aim and objective of constituting the Government Corporation in the name of Indian Air lines [IA] and Air India International [AI]. The preamble reads as under- “An Act to provide for the establishment of Air Corporation, to facilitate the execution by the air Corporation of undertakings belonging to certain existing Air companies and generally to make further and better provisions for the operation of air transport service”. Section 7 of the Act of 1953 mentions the functions of the Corporation. The section reads “Subject to the rules, if any, made by the Central Government in this behalf, it shall be the function of each of the Corporations to provide safe, efficient, adequate, economically and properly coordinated air transport service, whether National or International or both and the Corporations shall so exercise their powers as to secure that the Air Transport Services are developed to the best advantage and, in particular, so exercise those powers as to secure that the services are provided at reasonable charges”. On 15th June 1953 former independent companies, namely Air Service of India (A.S.I), Deccan Airways, Himalayan Aviation, Airways India, Bharat Airways and Kalinga Airlines were merged to form the new domestic

national carrier Indian Airlines Corporation (I.A.C/IA/IC). All these airlines have been privately owned, except Deccan in which the government held a 70% interest, purchased from the state of Hyderabad.

6.3 The Air Corporation Act of 1953

“The Act of 1953 provided the frame of regulations including prescribing terms and conditions of services of officers and other employees of Air India and Indian Airlines. The Air Corporation Act of 1953 was repealed by the Air Corporation (Transfer of undertakings and repeal) Act 1994. As a result of the Repeal Act, the erstwhile statutory corporation constituted under the Act of 1953 stood vested in the newly formed two companies Indian Airlines and Air India Ltd. Section 8 of the Repeal Act, which elaborates the conditions of service of all officers and employees of the erstwhile corporations, reads as under:- Section 8(1)- Every officer or other employee of a corporation (except a Director of the Board, Chairman, Managing Director or any other person entitled to manage the whole or a substantial part of the business and affairs of the corporation) serving in its employment immediately before the appointed day, shall, in so far as such officer or other employee is employed in connection with the undertaking which has vested in a company by virtue of this Act, become, as from the appointed day an officer or other employee, as the case may be, of the company in which the undertaking has vested and shall hold his office or service therein by the same tenure, at the same remuneration upon the same terms and conditions, with the same obligations and with the same rights and privileges as to leave, passage, Insurance, superannuation scheme, provident fund, other funds, retirement, pension, gratuity and other benefits as he would have held under that corporation if its undertaking had not vested in the company and shall continue to do so as an officer or other employee, as the case may be, of the company or until the expiry of a period of six months from the appointed day if such officer or other employee opts not to be the officer or other employee of the company within such period” (Report of expert committee on HR issues of merged Air India, 2012)

6.4 Initiation of Merger

Sometime between the years 2006-07, the government took a decision to amalgamate two government companies Indian Airlines and Air India Ltd. The declining market share and operating losses posed a serious threat for the future survival of the two airlines on a stand-alone basis. It was felt that as size of a company is a critical factor for the successes of an airline company merging both the airlines would give the company a fighting chance amidst fierce global and domestic competition, as it would provide an opportunity to leverage combined assets and capital better and build a stronger sustainable business. It was also felt that merging the airline would also give the company greater acceptability amongst the global alliances. It was emphasized that the merger could bring the following:

- a. “Enable optimal utilization of existing resources through improvement in load factors and yields on commonly serviced route as well as deploy freed up aircraft capacity on alternate routes.
- b. Provide an opportunity to leverage skilled and experienced manpower available with both the companies to the optimal potential.
- c. Provide an integrated international/domestic footprint which would significantly enhance customer proposition and allow easy entry into one of the three global airline alliances.
- d. Provide an opportunity to fully leverage strong assets, capabilities and infrastructure.
- e. Potential to launch high growth and profitability businesses (Ground Handling Services, Maintenance Repair and Overhaul etc.)” (Directors report Air India, 2007)

On 22nd March 2006 a presentation was made before the Prime Minister by Air India regarding the merger. During the discussions held after the presentation, apprehensions were expressed with regard to the HR problems that might arise due to merger. However, it was felt that it would be in the overall interest of both AIL and IAL to sort out these issues and work towards merger under the guidance of MoCA (Ministry of Civil Aviation). The business case for the merger was finalized after reviewing the following aspects:

- a. “Overall Aviation scenario globally and in India – increased competition from private and foreign carriers
- b. Increasingly overlapping roles of erstwhile Air India and Indian Airlines cannibalizing on each other’s business
- c. Deteriorating operating and financial performance vis-à-vis competition

- d. Need for a flag carrier with an integrated domestic and international footprint
- e. Expected synergies from merger and costs of merger.” (Committee of public undertaking report,2009-2010).

The government was the owner of both airlines and the decision to merge the two was taken after consulting all the stakeholders. The synergies derived from the merger were expected to grow up over the years. These include revenue synergies driven primarily by the network integration of both airlines and cost and capital synergies driven by consolidation and better negotiation.

6.4.1 Merger process

During the discussions, Ministry of Civil Aviation suggested that there is a possibility of forming a holding company for both Air India and Indian Airlines preceding their full merger. After detailed discussion, ‘in principle’ approval was given for working towards the merger of Air India and Indian Airline. Air India appointed Accenture as the consultant for merger. “On July 2006 Joint Committee of Boards of AI and IC on Merger (constituted by GoI) selected Accenture India Pvt. Ltd. as the consultant to advice on the merger.

GoM (Group of Ministers) agreed with the merger proposal, and decided that GoI would provide the necessary relaxation from the existing norms/ rules on need basis for effecting the merger quickly. MoCA held meetings with employee associations of AI and IC. GoM decided to recommend to the Cabinet that the proposal for merger be approved.

The Ministry of Corporate Affairs, Government of India, vide Order dated 22 August, 2007 approved the Scheme of Amalgamation of Air India Limited and Indian Airlines Limited with the National Aviation Company of India Ltd. under Sections 391-394 of the Companies Act and on filing the Order with the Registrar of Companies, New Delhi the merger became effective from 27 August 2007. The authorized share capital of the Company was increased from Rs. 5 lakhs to Rs. 1500.05 crores. The paid-up Share Capital was increased from Rs. 5 lakhs to Rs. 145 crores. The entire Paid-up Capital was hold by the Government of India. AIL

and IAL/IC stood dissolved and merged into NACIL. The newly formed National Aviation Company of India Limited was renamed in Nov 2010 as Air India Limited (AI) under the administrative control of the Ministry of Civil Aviation. The Company's registered office is at Parliament Street which is in New Delhi and its head quarter is at Nariman Point in Mumbai" (Performance audit report of civil aviation in India 2007-2008).

6.4.2 Objectives and Envisaged Benefits of Merger

According to the consultant (Accenture), the merger was intended to:

- "Provide an integrated international/ domestic footprint, which would significantly enhance customer proposition and allow easy entry into one of the three global airline alliances; namely Star Alliance, One World and Sky Team.
- Enable optimal utilization of existing resources through improvement in load factors and yields on commonly serviced routes, as well as deploy 'freed up' aircraft capacity on alternate routes;
- Provide an opportunity to fully leverage strong assets, capabilities and infrastructure:
- Parking bays and landing slots in an 'infrastructure constrained' environment;
- Potential to launch high growth & profitability businesses {Ground Handling Services (GHS); Maintenance, Repair & Overhaul (MRO) etc.};
- Potentially enable the merged entity to command better valuation;
- Operate a combined fleet strength (~112), which would be the largest in India and comparable to other airlines in Asia/Region {Emirates (93), Singapore (118), Malaysian(110);
- Provide maximum flexibility to achieve financial and capital restructuring through revaluation of assets and cleaning up of financial books."

According to the consultant (Accenture), the following benefits were envisaged:

- "Net synergy benefits of Rs. 820 crore (against the integration cost of Rs. 200 crore) was envisaged; potential recurring synergies were expected to enhance profitability by Rs. 600 crore at the end of the 3rd year of merger.
- The merger would make the combined airline the largest in the country, improve combined market share, result in a combined balance sheet (which would be important for an IPO), and revaluation of assets of both airlines (which would be possible only after a merger) and improve net worth."

"The Accenture report expected synergies on two counts – revenue synergies (primarily on account of network integration) and cost and capital productivity synergies (leveraging economies of scale for rates for catering, crew boarding and lodging etc.; opportunities for

rationalizing overlapping facilities and infrastructure e.g. international locations serviced by both airlines). A figure of Rs. 820 crore on account of synergies at the end of the third year after merger was projected by the consultant.

One of the key assumptions for improved employee productivity was that the merged entity would have fewer employees/ aircraft on account of increase of fleet and reduction of employee base by expected retirements. However, such expected improvement in employee productivity had not been achieved, and was, in any, case not directly dependent on the merger” (CAG report on performance audit of civil aviation sector, 2009-2010).

6.5 Problem

Air India is passing through severe financial crisis. Air India has taken huge bank loans to buy new aircrafts and meet the company’s working capital requirement. The losses of Air India are growing exponentially. There are several reasons behind this current financial mess like liberalized sky policy, huge delay in the actualization of the merger etc. Post merger the loss figures has increased manifolds compared to pre- merger. The company in its annual accounts has shown losses for the last 5-6 years. There are several reasons for this crisis which have occurred because of the decision of merger. Although the legal merger was done few years ago actual merger is yet to take place. HR integration still remains as a big problem, apart from that several technical issues regarding merger are still pending. All in all the entire decision of merger has turned out to be a big mistake.

From FY08 to FY12 inclusive Air India accumulated losses of close to \$5.25 billion. Of the 189 routes that the Maharaja operates, only 12 meet total costs. A further 82 cover their cash costs but not their total costs and 95 routes, or just over half, do not even meet their cash costs. International routes are bleeding particularly badly and account for 80-90% of losses. Air India’s debt is approximately twice that of all the other carriers combined. Bank loans and aircraft-related debt total approximately \$9 billion, in addition to which there are vendor-related liabilities, e.g., to fuel suppliers and airport operators, in excess of \$1 billion. The net

profit/loss of Air India and Indian Airlines after tax, for last few years before the merger and after the merger is given below

Pre merger figures are

(Rs in crore), figures in brackets signify Net loss.

Year	Air India	Indian Airlines
1997-98	(181.01)	47.27
1998-99	(174.48)	13.12
1999-2000	(37.63)	45.27
2000-01	(44.40)	(159.17)
2001-02	15.44	(246.75)
2002-03	133.86	(196.56)
2003-04	92.33	44.17
2004-05	96.36	65.61
2005-06	14.94	49.50
2006-07	(447.93)	(240.29)

Post merger

2007-08	(2,226.16)
2008-09	(5,548.26)
2009-10	(5,552.44)
2010-11	(6,665.17)
2011-12	(7,853)
2012-13	(5,198)

(source: Company report and Airlines business)

The reasons for the crisis of Air India can be divided in two types: external reasons and internal reasons. External causes are the problems which exists outside the company, threats which come from the external environment. These challenges are uncontrollable, but the strategies taken by the company should take into account of the potential threat otherwise these threats become causes for a company's failure. The same happened with Air India. In the previous chapter we have seen the challenges of Aviation Industry here we will see how these challenges have effected Air India.

- Rising ATF prices & steep rupee depreciation
- Rules and regulations
- Bilateral agreements and open sky policies

- Economic slowdown

On the contrary internal causes refer to problems initiated by the company management, problems which has aroused due to improper decisions. These factors are controllable but Air India failed to control it.

- Huge Delays in Actualization of Merger/ Integration
- Aircraft acquisition
- Risks of Debt Funded Acquisition
- Route Rationalization and Network Integration and its impact
- Proper utilization of assets and infrastructure
- HR and IR issues
- Role of management and Government intervention

These are the major causes behind its current financial crisis. Below we will discuss all the causes in details

External cause

6.5.1 Rising ATF (Aviation Turbine Fuel) Prices & Steep Rupee Depreciation

Oil is one of the most important inputs for an airline, is a globally traded commodity. Oil price is determined by market forces of demand and supply. These market forces are influenced not just by geological but also socio-political factors. Oil price is also dominated in US dollars, while many of the international airlines earn a substantial percentage of their revenues in local currencies. Consequently, many international airlines incur a significant element of foreign exchange risk. In addition to oil prices, governments and local airports impose landing charges and aircraft parking fees, over which an airline company has no control. Further issues such as the quality of the local infrastructure also impact the growth and profitability of airlines.

India's multilayer fuel taxation system which includes the central excise duty and sales tax levied by the state governments (varying from 4% to 30%) limits Indian carriers to compete with foreign carriers providing international carrier services. Furthermore, within India's civil

aviation sector, pricing of ATF is determined by a small number of suppliers. High fuel expenses prevent Indian airlines from buying more aircraft and servicing more routes, which in turn contributes to overall market growth. Currently, fuel expenses make up approximately 40% of an airline's operational expenses. The high cost of ATF adversely affects the profitability of airlines in India. The ATF is subject to high central exercise and high sales tax and also have major state level difference.

6.5.2 Rules and regulations

As India's civil aviation sector developed and evolved over time, in order to guide market participants the Ministry of Civil Aviation and Government of India periodically responded to new industry challenges by setting up and amending existing regulatory frameworks. Until 1994 the Directorate General of Civil Aviation (DGCA) controlled every aspect of flying including the licensing of pilots, certifying aircraft and issuing all rules and procedures governing Indian airports and airspace. However, in 1994 an Act of Parliament established the Airports Authority of India (AAI). This Act gave the AAI the power to manage all national and international airports and administer every aspect of air transport operation through the air traffic control.

In 2008, the Airports Economic Regulatory Authority of India Act established the Airports Economic Regulatory Authority (AERA) of India. AERA regulates tariffs and other aeronautical charges, as well as monitors airports' performance standards. Some of the other areas of control by the government which has an impact on the airlines business are as follows.

6.5.2.1 Fleet and Equity Requirements for Domestic Passenger Air Service:

The cost of entry into the civil aviation sector is naturally high (even in the absence of fleet and equity requirements), these regulations further raise barriers to entry. Therefore, fleet and equity requirements limit not only the number of new market entrants, but also the size of firms that enter. In the case of India's civil aviation sector, there are relatively few market participants, who are fairly large service providers and are generally familiar with their

competitors' strategies and pricing. Without new and unfamiliar competitors entering the market, chances are less that these established airlines will change their operation and therefore, customer service and choice are adversely affected.

6.5.2.2 Fleet, Equity and Experience Requirements for International Air Transport

Fleet, equity and experience requirements deter entry and thereby reduce consumer choice of international passenger air carriers. For example, from 2004 to 2010 the Indian government raised capacity entitlements for international carriers four-fold; however, Indian carriers were unable to take advantage of this increase, because these carriers did not have enough planes - as required by Civil Aviation Requirements (CAR) - while foreign carriers took the benefits.

6.5.3 Bilateral Agreements and open sky policy

During past five years as a result of open skies with USA, near open skies with UK/ASEAN/SAARC along with liberal bilateral agreements with other countries there has been huge increase in entitlements/new routes for foreign airlines. It is often argued that these agreements have benefited foreign carriers compared to its Indian rivals. Since for Indian airlines 5 years domestic experience is mandatory for international operation often unused permissible routes go to foreign carriers.

An airline company plans its international route network based on the bilateral rights. The Government of India's stance on bilateral rights has lacked clarity and transparency which makes it virtually impossible for Indian carriers to plan their international strategy. From 2004 the market was opened up rapidly, only for bilateral rights to be frozen again from 2008.

6.5.4 Economic Slowdown

It is important to note that the entire Aviation industry was affected globally due to the recessionary trends of 2008-2009. The same was primarily due to rising fuel prices and

exceptionally weak yields. As per IATA, three main factors were responsible for the losses: low demand, low yield and high fuel price.

The position of airlines in India was also similar and there were pressure both on yields as well as load factors as there was excess capacity in the market and demand had shrunk. The big question was that at a time when their revenues were barely Rs.7,000 crores and when they had to pay an interest of nearly Rs.6,500 crores per annum, what prompted Air India (AI) to go in for a new fleet costing thousands of crores of rupees (approximately Rs.44,000 crores).

Fleet acquisition plan by erstwhile Air India and Indian Airlines was made during 2002-2005. The plan was designed based on the then aviation market and assumptions of further development based on industry indicators. But the major problems with these plans were it was based on assumptions. Since there was a slump in the aviation industry during 2008-2009 all the predictions and plans went wrong and the entire fleet acquisition plan turned into a big mistake resulting in huge financial losses. Moreover all the synergy benefits expected out of the merger (AI and IA) did not fulfill as soon after merger the aviation industry was in the middle of financial crisis. Whatever network integration the new aircrafts were expected to bring did not materialize primarily due to the recession and huge rise in fuel prices, losses were suffered not only by AI but by the entire Aviation industry in India and globally.

Internal Cause.

6.5.5. Huge Delays in Actualization of Merger/ Integration

Although the merger of AI and IC was officially notified in 2007, the integration process had still not been fully completed, as described below:

6.5.5.1 Delays in implementing Single Code Passenger Reservation System

One important element of the integration of the networks of the erstwhile Air India and Indian Airlines was the integration of the reservation systems. The objective of the merged entity

(AIL) was to operate all its flights on a single code. “Prior to the merger, the two airlines were using separate reservation systems (UNYSIS system by AIL and IBM system by IAL) with separate airline codes (IC for Indian Airlines flights and AI for Air India flights).” MOCA announced in Parliament on 2 March 2007 that the merged airline with one code will start functioning within 16 weeks, but finally it was done in February 2011 four years after the merger.

6.5.5.2 Membership of “Star Alliance”

In aviation industry joining airline is something very important. It helps to bring together networks, lounge access, check-in-services, ticketing, etc. It also reduces the costs of individual airlines from economies of scale. Joining the Star Alliance is very important for AI as it can help to improve its precarious financial health. Consequently, one of the targeted objectives of the merger included easy entry into one of the three global airline alliances. “After paying an entry fee advance of €5 million in June 2008, AI’s entry into the Star Alliance was intended to take place in March 2009. The balance of €5 million was required to be paid at the time of entry into the alliance. Out of the pre-requisites for joining the alliance (Minimum Joining Requirements – MJR), the most important requirement was a passenger reservation system with a single code” for both the erstwhile airlines, which did not take place until February 2011. Star Alliance was not ready to extend the timeline beyond 30 June 2010. Thus, AI failed to join star Alliance. “While financially AI still has loan-cum-losses figure of close to Rs 1 lakh crore, AI had decided not to seek a refund of its membership application fees to remain on hold, and thereby not allow any other Indian airline to join the alliance before it.”

6.5.6 Aircraft acquisition

Air India’s decision to acquire huge number of aircrafts is one of the primary reasons behind its current financial crisis. Below we will discuss it in detail to understand the impact of this decision.

6.5.6.1 Acquisition of aircraft by erstwhile Air India limited (AIL)

In December 1996 erstwhile AIL's proposal for acquisition of 3 A310-300 aircraft was not cleared by MoCA (Ministry of Civil Aviation) due to reasons like availability of excess A-320 type of aircraft with the erstwhile IAL. Expert committee was constituted by AIL to identify aircraft requirement and prepare fleet plan for 5 year time frame.

“January 2000- Techno Economic and Negotiation Committee (TENC) was constituted by MD, AIL for finalization of requirement of aircraft.

November 2002-TENC submitted separate reports for acquisition of: 17 (10 on firm basis + 7 on option basis) medium capacity long range aircraft (A340-300 / B777-200 ER); and 18 short range aircraft (A320-200 / B737-800).

April/July 2003- After review, TENC submitted a revised report for 18 short range and 10 or 17 long range aircraft on the basis of revised pattern of operations.

November 2003- AIL Board approved proposal for acquisition of 10 medium capacity long range aircraft (A340-300) and 18 small capacity short range aircraft (B737-800). AIL submitted project report for acquisition of 28 aircraft to MoCA.

January 2004- In a meeting chaired by the then Minister, Civil Aviation it was decided that Air India should revisit the proposal for purchase of aircraft and submit a fresh project proposal to the Government at the earliest which could include the revised requirement.

August 2004- Based on the decision taken in the meeting of 2nd August, 2004, as communicated in the Ministry's letter dated 5th August, 2004, the Board of Directors of Air India in its 101st meeting decided that the fleet plan could be revisited in its entirety.

September 2004- AIL Board approved a revised plan for acquisition of 50 aircraft for AIL, apart from 18 aircraft for its subsidiary AICL (Air India Charters' Ltd.).

November 2004-Bids were invited from Boeing and Airbus.

3rd December 2004-Technical bids were opened.

24th December 2004-TENC evaluated bids and submitted its report.

April 2005- AIL Board approved the acquisition of 50 aircraft (35 firm + 15 on option) from Boeing with GE engines.

May 2005-Project Report for GoI approval for acquisition of aircraft was submitted to MoCA.

16th June 2005- Price Negotiation Committee was constituted by AIL, with ‘in principle’ approval of MoCA.

30th June 2005- Presentation was made by AIL to MoCA on aircraft acquisition. ‘Overseeing Committee’ was constituted by MoCA to oversee the process of price negotiations with Boeing and GE for acquisition of aircraft.

August 2005- Pre- PIB (Public Investment Board) meeting was held. PIB cleared the aircraft acquisition at a cost not exceeding Rs. 33,197 crore. CCEA (Cabinet Committee on Economic Affairs) approved constitution of EGoM (Empowered Group of Ministers) for final round of negotiation with lowest bidder. Cabinet Secretariat communicated constitution of EGoM. EGoM held discussions with the representatives of Boeing and GE. PMO (Prime Minister’s Office) forwarded a copy of the note of the Chairman, EGoM to the PM on the action taken by the EGoM, where it approved acquisition of 50 aircraft by AIL on firm basis, in addition to acquisition of 18 aircraft for Air India Charters’ Ltd. (AIC). PMO returned the note indicating that the “Prime Minister has seen the note and directed that the Ministry of Civil Aviation may inform CCEA about the finalized transaction”. MoCA conveyed GoI’s approval to AIL. On the same day, AIL also signed purchase agreements.”

There is no doubt that the erstwhile AIL desperately needed to acquire new aircraft. Due to lack of timely acquisition, AIL had to induct 13 additional aircraft on dry lease by January 2004. AIL’s proposal of December 1996 for aircraft acquisition was not cleared, and a fresh process for acquisition was initiated only in January 2002. Thus, it took nearly eight years (December 1996 to January 2004) when AIL finally came before Government with a firm acquisition proposal. Such an unduly delayed acquisition process is dangerous for the financial health of a commercial airline. Interestingly, although the original proposal for acquisition of 18 + 10 aircraft took long time for processing, the revised proposal for acquisition of 18 + 50 aircraft was processed considerably faster.

Change in number of aircraft to purchase and its impact

“The erstwhile AIL’s project report of January 2004 proposed acquisition of 10 medium capacity long range aircraft (A340-300) and 18 small capacity short range aircraft (B737- 800). However, by November 2004, the AIL Board changed their fleet acquisition plan and

submitted a revised proposal for acquisition of 50 medium capacity long range/ ultra long range aircraft, in addition to 18 small capacity short range aircraft for its subsidiary, Air India Charters Ltd. (AICL).” For reasons unknown the number of aircraft requirement was increased between January 2004 and August 2004. The assumption that increase in capacity share would automatically lead to an increase in AIL’s market share was not adequately validated. Whatever chances AI had of increasing market share through increased capacity share were severely hampered by the MoCA’s decision to liberalize bilateral entitlements from 2005 onwards, benefiting airlines/ countries with huge proportion of 6th freedom traffic and giving inadequate lead time for AI (after delivery of the aircraft) for gearing itself up for competition.

AIL and AICL signed the purchase agreements with Boeing, however, no benchmarks for the cost of the aircraft were set by AIL/ MoCA before negotiations were initiated with the manufacturers at various levels. Consequently, in the absence of such benchmarks, the effectiveness and efficiency of negotiations and the price arrived at was difficult to ascertain.

Delivery and further problem

“On 11 January 2006, Air India announced an order for 68 jets – 8 Boeing 777-200LR Worldliners, 15 Boeing 777-300ER, 18 Boeing 737-800 and 27 Boeing 787-8 Dreamliners. Air India has taken the delivery of 6 Dreamliners so far. All remaining Dreamliners are expected to be delivered by 2016.” The carrier was to get delivery in May 2008, which got pushed forward for a variety of reasons, including manufacturing delays. The Dreamliners were an integral part of AI’s turnaround plan, as the plane can fly up to 16,000 km non-stop and highly fuel-efficient. Due to the delay of delivery the turnaround plan and route integration could not materialize on time. The national carrier's first Dreamliner arrived in New Delhi in, 2012. The Dreamliners’ were supposed to be used for international routes, but started flying on domestic routes from September 2012.

The Directorate General of Civil Aviation in January 2013 asked Air India to cease Dreamliner operations due to technical problems. The DGCA took the decision to ground the aircraft after it received a global advisory from the FAA (Federal Aviation Administration). “Air India’s (AI) grounding of its Boeing-787 Dreamliners’ started adding to the airlines’ fuel cost by

around Rs 40 lakh daily, apart from forcing changes in flight schedules.” The insurance cover Air India took from Boeing could not cover the financial losses as in traditional fleet insurance policies; only damages caused by major accidents and natural catastrophe are covered. Hence, if an airline's fleet is grounded due to regulatory issues, the insurance company is not liable to pay. The fleet insurance policy did not cover revenue loss due to grounding. After long delay and huge losses Dreamliners’ finally started flying from May 2013.

6.5.6.2 Acquisition of aircraft by erstwhile IAL: problems and prospects

In February 2006, the erstwhile Indian Airlines Limited (IAL) signed purchase agreements with Airbus/ CFM for supply of 43 Airbus aircraft (with CFM engines) at an estimated cost of Rs. 8399.60 crore.

The last fleet expansion of IAL was completed in 1994. IAL’s aircraft acquisition process took almost ten years from October 1996 (when an in-house aircraft evaluation committee was constituted) to February 2006 (when the purchase agreements were finally signed). The Planning Commission and the Department of Expenditure (DoE) raised concerns on several key and critical issues at different stages (initial stage, pre-PIB meetings, and PIB meetings) but finally approved the acquisition proposal.

The main concerns of the Planning Commission at different points of time are summarized below:

- “The Planning Commission representative indicated that new accretion to capacity had to be viewed with great circumspection, and suggested that IAL should consider purchasing only 28 aircraft at this stage, and the rest in Phase-II, after reviewing the situation, depending on the growth of traffic.
- The aircraft requirement, at least for international routes, could be reduced, as it would be appropriate for IAL and AIL to chalk out a common strategy for their international operations, as they were competing with each other along with other international airlines on some international routes.
- The company was incurring losses over the years, and it was necessary to evolve a suitable strategy for funding the acquisition plan to avoid time and cost overrun. Further, operating more aircraft to compete with the private sector might lead to further deterioration of IAL’s financial position.”

The main concerns of the Department of Expenditure (DoE) at different stages are summarised below:

- “It would be prudent to go in for some options, rather than placing orders for all 43 aircraft on a firm basis, as the projected fare hikes and load factors on international sectors might not materialize in the competitive market scenario.
- The pressure of competition was much more intense on international sectors than in the domestic sector, with more bilateral rights being granted in these sectors and the possibility of other domestic scheduled operators being granted international rights. Consequently, the projections of load factors on international sectors may not materialize in the long run.”

In the PIB (Public Investment Board) meeting of November 2004, MoCA and IAL justified the projections in the Project Report on the following grounds:

“Fare increase may not be really difficult in the present scenario.

- The capacity addition was justifiable, as the market was growing at a rate of 7.8 *per cent* p.a. over the 2000-01 level, and the annual growth projection of 5 per cent in the X Plan was on a conservative side.
- Market share of IAL would be directly related to its capacity share.
- The proposal to permit domestic carriers to fly on domestic and international routes had been duly considered.”

According to CAG (Comptroller and Auditor General) report, “the representatives of the Planning Commission and Department of Expenditure chose not to press their concerns expressed earlier (after taking note of MOCA/ IAL’s response), and finally agreed to the MoCA proposal for acquisition of 43 aircraft by IAL. IAL’s claim that an increase in capacity would automatically result in a proportionate increase of market share was not adequately validated. Inexplicably, integrated operation between AIL and IAL (even though this was recommended before the finalization of the fleet acquisition process) was not taken into consideration as part of the acquisition project analysis either for AIL or IAL. In fact, according to their projected fleet deployment plan IAL was expected to compete with AIL on some international routes. Inexplicably, the need for such synergy/ integration was accepted only after expensive fleet acquisition processes were carried out independently by both airlines.”

6.5.6.3 General problem with the acquisition process and analysis

Air India's fleet utilization is very poor with only around 100 operational aircraft out of a total registered fleet of 127 aircraft (including Air India Express). And even those aircraft in service have daily utilization rates below the industry average. Meanwhile, Air India's long-haul operations remain compromised by wide-body fleet issues. There is a mismatch of aircraft type and Air India's operations. As a result, aircraft which are ideally suited to long-range routes are instead being sub-optimally deployed on medium-haul routes with relatively low utilization.

The opening up of bilaterals and the strengthened competition will put extra pressure on Air India from Indian and foreign carriers. LCCs and sixth freedom right, imposes a structural limitation on its long term business plan. Air India is already bleeding badly on international routes and these developments will significantly weaken the business case.

In conclusion it can be inferred from the above information that undue time taken for fleet acquisition, absence of proper strategic planning coupled with technical fault complicated fleet acquisition for AI. Thus, this lengthy and complicated fleet acquisition process is one of the important reasons for the crisis of Air India. The report of the Comptroller and Auditor General (CAG) on aircraft purchases has confirmed what has thus far been widely known: that Air India has been forced to acquire more aircraft than it needed or could afford. It remains to be seen how far the government will go in holding those responsible for it accountable since this one single decision has virtually brought Air India to the brink of financial bankruptcy. Air India's planning department had been cautious in recommending ordering of 35 aircraft based on presumptions made on load factors, route expansion, revenues, etc. The planning department warned that, if the market does not grow at the pace visualized or the government brings a dramatic shift in market dynamics through liberal grant of rights to foreign carriers, which it did subsequently, the acquisition plan will create extreme financial pressure on the company.

Even if one give the benefit of doubt to the then civil aviation minister Praful Patel that he got Air India so many aircraft because he wanted the national carrier to regain its market share and grow aggressively in a rapidly growing aviation market, one wonders what role the then Chairman, V. Thulasidas and the Board of Air India played? Were they party to the decision? If

yes, they ought to be subjected to scrutiny considering the fact that none of the milestones assumed for justifying increase in number of aircraft to be purchased have been attained.

6.5.7 Risks of Debt Funded Acquisition

The fleet acquisition cost for both AIL and IAL was funded entirely through debt (except for a marginal equity infusion of Rs. 325 crore in respect of IAL). The adverse impact of debt-funded acquisition (with extraordinarily high Debt-Equity ratios) and interest/ principal repayment was felt by AI, essentially from 2009-10 onwards., and will continue for the foreseeable future, unless there is substantial equity infusion by government of India.

Based on the approval of Cabinet Committee on Economic Affairs, “Government has so far approved Rs.2000 crore as equity investment in Air India during the year 2009-10 and 2010-11. Air India, with a working capital debt of over Rs 17,000 crore and an initial equity capital of Rs 145 crore, the ratio of debt to equity was almost 120:1 until the infusion by the government in 2010-2011. Loans to AI have been given by public sector banks under government pressure, and against their own better commercial judgments. There is a limit to how much longer they can continue giving such loans-which keep the airline afloat. Air India has already borrowed about Rs 25,000 crore to pay for aircraft recently received. Interests’ payments on these loans are already adding to the airline’s debt burden. There are also some unsecured debts owed to Air India’s vendors and oil companies. Air India also owes money to state-owned Airports Authority of India. These amounts keep rising day by the day.”

It was only in 2012 government took the decision of injecting over Rs. 30000 cr. Over a period of nine years as part of the company’s financial restructuring plan starting from 2012-2013. According to Air India’s turnaround plan, the government is to infuse Rs 24,400 crore in the carrier from 2012-13 to 2016-17. But the government’s infusion plan seems unlikely to be fulfilled. The government has also defaulted on the equity infusion promised to Air India in the first fiscal. Of the infusion of Rs 10,600 crore for the first fiscal, Air India got Rs 6,000 crore in the first year. However, due to the unavailability of promised money, Air India is forced to borrow money from banks and clear their dues that are at a higher interest rate.

6.5.8 Route Rationalization and Network Integration and its impact

Soon after the merger of Air India (AI) and Indian Airlines (IC), AI started re-structuring its routes. Route rationalization was done by identifying overlapping operations between the erstwhile airlines in Middle East and East Asia. A Strategic Group was formed (August 2008) by AI Board to restructure its route plan. The task of the group was to identify and withdraw flights from routes not meeting cash costs. During 2008-09 and 2009-10, loss making international and domestic services were withdrawn and routes were restructured to reduce costs/ losses. Further, the launch of T-3 (Terminal -3) at New Delhi enabled AI to designate Delhi as the hub for integration of international and domestic operations.

AI surrendered many routes to private airlines. Management explained that the withdrawal of services were on account of non-availability of suitable / sufficient aircraft and loss making nature of those routes. Before the merger erstwhile Air India and erstwhile Indian Airlines were unable to increase capacity due to shortage of aircrafts while the private airlines increased their capacities. Consequently, erstwhile Indian Airlines operations on some of the domestic routes got marginalized by increased frequencies / capacities offered by the competitors on these routes. As a result, losses began to increase and IC started losing market share. This trend continued even after the merger. The entry of low cost carriers put further pressure on Air India. In a bid to hold on to its market share, AI was also compelled to drop its fares on the domestic routes. The reduction in fares has also been partially responsible for AI's current financial position. It also forced the company to discontinue its operations on some other routes. Right now most of the routes covered by AI do not cover cash cost.

AI has to develop its route network keeping in mind the social responsibility aspect. The social responsibility aspect influences AI's route network perhaps more than that of its competitors. As a government airline AI is required to respond to National requirements such as flying to unprofitable routes like the North-East, operation of charter flights, relief flights, Haj charters, etc. These social obligations compel Air India to divert capacity from scheduled services thereby disrupting these schedules. Maintaining connectivity to remote and underserved

markets is woven into AI's network planning systems whereas private airlines develop their network based solely on profitability / network synergies. AI continues to bear these losses in the absence of any subsidy/ reimbursement of losses being provided by the government.

6.5.9 Proper utilization of assets and infrastructure

Air India is often accused of misusing or under using its assets. Improper use of its assets and infrastructure is a crucial reason behind the financial crisis that the company is currently experiencing.

6.5.9.1 Immovable assets

Immovable assets worth crores of rupees are lying under-utilized. The Engineering infrastructure for repairs and maintenance of air crafts in the Hangars and Work Shops at Mumbai, Delhi and Hyderabad are grossly under-utilized. Air India has large number of real estate properties in India and abroad at several locations like big office infrastructure at Nariman Point Mumbai, huge accommodations of erstwhile IA and AI at Delhi, a very big chunk of land near the Training Centre at Hyderabad, etc. Most of these properties are under utilized and have not been put to profitable use so far.

6.5.9.2 Wasteful expenditures

Air India is currently passing through severe financial crisis. It is, therefore, necessary for the management of Air India to identify wasteful expenditures in various departments so that it can introduce some measures to avoid wasteful expenditure. Air India is highly over staffed and its manpower to aircraft ratio is very high compared to the domestic as well as international aviation industrial practices in the market.

Some particular areas where there is wasteful expenditure and improper utilization of its resources can be pointed out. In order to ensure cost rationalization, AI must ensure a substantial increase in ticket sales through web based channels, rather than agents/ front offices.

The current proportion of ticket sales through AI's website is very low. Currently, self handling is not permitted so profitable business of ground handling is going to foreign companies. This has also resulted in labor displacement. Joint venture with SATS and MRO with Boeing is heavily loaded in favor of SATS and Boeing. Surplus inventory should be sold. Spares disposal policy can bring savings.

AI office at Ahmadabad is unutilized. Other wasteful expenditure like quantity and quality control of flight catering at foreign stations; huge payouts on account of taxi fare for non delivery of baggage; VIP flights resulting in disruption of schedules should be managed immediately. Advertisement should be purely for the revenue earnings of the airline and should also be effective. Technology can be used to reduce expenditure wherever possible as in telecom, video conferencing etc. Review and curtail all non essential expenditure of foreign offices; rentals; car expenses entertainment expenses on visiting airlines officials and others need to be closely monitored. Immediate combining of common offices of IC and AI in foreign countries are some important steps that are yet to be implemented.

It is clear from the above discussion that the company is currently bearing a lot of unnecessary expenses. A company which is in a severe financial crisis should scrutiny all avenues to increase savings. On the contrary, it is having extra expenditure for everything. This is again the work of management to control these extra expenses which the company currently cannot afford given its disastrous financial health. But unfortunately, management is not doing anything and every month the company is wasting crores of money.

6.5.10 HR and IR issues

Post merger the biggest problem Air India is currently facing is regarding the management of its human resources. The Annual Report of 2007-08 elaborated in detail, the object of amalgamation of AI and IA as under:

“On amalgamation of erstwhile IA and AI, the main problem arose of increased integration of services of employees of erstwhile two government companies. When the scheme of amalgamation was considered by the Government of India for approval in accordance with Companies Act, the employees strongly objected

to the amalgamation or the merger of the two companies on the ground that their service conditions would be adversely affected. At the time of seeking approval of the amalgamation scheme on behalf of the companies, an assurance was given that “manpower of both the Airlines would be integrated gradually in a calibrated approach and broad principles. Manpower integration would be as under:

- i. There will be no retrenchment and all employees will continue in the merged company.
- ii. All legitimate rights of the employees will be protected.
- iii. The issue regarding determination of inter-se seniority, compensation etc. would be addressed on the basis of transparent and objective criteria as per law.”

Employees of both erstwhile Air India and erstwhile Indian Airlines opposed the merger decisions as they were not sure about their service conditions post merger. The management gave assurance that post merger “terms and conditions of service of the employees in the transferred company shall not be less favorable to the terms and conditions available to them to the transferor company”. This assurance was accepted by the Government of India.

Justice Krishna Iyer has observed: “[in the case of T.N. Education Department Ministerial and General Subordinate Service Association V. State of Tamil Nadu (AIR 1980 SC 379)]. “In service jurisprudence, integration is a complicated administrative problem where, in doing broad justice to many, some bruises to a few cannot be ruled out. Some play in the joints, even some wobbling, must be left to government without fussy forensic monitoring All life, including administrative life, involves experiments, trial and error, but within the leading strings of fundamental rights and absent unconstitutional excesses”. Thus in the case of merger of IA and AI it is not possible to satisfy every class and every individual on the two sides and this made the merger even more complicated. Both the organizations have several unions and they have different issues and demands. This is one of the main Human resource related problem which merged Air India is currently experiencing. The merger of erstwhile Air India and Indian Airlines formally and legally took place in 2007, but the actual merger and integration of services of the employees of two erstwhile companies is yet to take place. This has resulted in frustration and demoralization of the employees of the merged entity. There were frequent agitations and strikes leading to disruption of air services. The productivity of Air India’s over staffed workforce continues to be a major challenge. The prospect of industrial action is always in the background, especially for licensed staff such as pilots and engineers.

One of the basic objectives of merger of erstwhile Air India and Indian Airlines has been to provide an opportunity to leverage skilled and experienced manpower available with both the companies to their optimal potential, which would significantly enhance customer orientation. However, these objectives are yet to fructify given the fact that the two erstwhile airlines continue to live in the heart and mind of the employees. Air India's aircraft to staff ratio is 1:230, whereas Industry average is 1:100. There is a huge wage disparity 20% staff get 80% of wage bill. There are illegal and illogical payments to certain categories. Performance Linked Incentives (PLI) is not transparent at the same time PLI is being manipulated and tampered. Some of the areas where AI and IC still follow different policies are stated below.

6.5.10.1 Working hour

Even after so many years of formal merger, erstwhile AI and IA are still maintaining different working hours for their employees. Air India is following 6 days a week schedule, whereas IA follows 5 days a week schedule. As per industry standards a company should have minimum 44 working hours per week. Reservation offices and sales and marketing wings of AI are working up to 44 hours a week (7days) whereas non-operating departments e.g. Finance/Personnel /Planning/ Vigilance/Internal Audit etc., are working only 38 hours a week.

6.5.10.2 Organizational culture

The organizational culture; managerial styles and structures were very different in IC and AI. Although the two companies have the same administrative Ministry they had different managements all along and had followed distinctly different personnel policies in terms of pay scales, recruitment procedures, promotion, etc. Post merger the companies are still following different personnel policies. Further the rules and guidelines laid down by the Department of Public Enterprises (DPE) for all the public sector enterprises particularly in the matter of salary structure and PLI were not followed by these airlines. This made the task of integration of two structurally incompatible organizations with about 33000 employees very difficult. The assurances given at the time of the merger that no one would be 'worse off' on account of the merger is making the situation even more complicated.

6.5.10.3 Hierarchies of posts

In the two erstwhile organizations, there were comparable hierarchies of posts. The very object of merger was to integrate the services and utilize the manpower of the two organizations in the merged entity for the optimum benefit of the company. Unfortunately, even after merger AI and IC still follow different positions based on their pre-merger requirements. This is not healthy for any merged company as it results in overstaffing and wastage of manpower.

6.5.10.4 Promotion

Pre-merger and post merger policy of promotion on the side of AI and IA had been different. For certain posts, AI had adopted the policy of time-bound promotion with age bar for promotion. On the other side IA promotions were based on selection procedure through a duly constituted committee. This difference in the promotion policy resulted in speedier career growth on the side of AI and slower career growth on the side of IA as the chances of promotion and number of vacancies also differed substantially. IA being mainly operating domestic carrier had a larger work force compared to AI which was operating internationally for limited number of routes. This kind of policy has created much complications and differences.

6.5.10.5 Pay Scales

Neither AI nor IC has followed the guidelines on pay scales and other perks lay down by the Government for its Public enterprises (DPE). This is the primary reason for variations in the pay scales in these two Airlines. Although neither erstwhile Air India nor erstwhile Indian airlines were profit earning enterprises, higher pay package in the form of allowances were given to the employees of both the companies. During pay revisions made in 1992 and 1997; different pay scales were given for similar levels/grades in the two airlines. Further, new levels were introduced which were not in conformity with the DPE guidelines. Post merger the company is still following different pay scales.

Presently, the company gives allowances much higher than the salary paid to the employees for the post they hold. Going strictly by the DPE Guidelines, salary cannot be paid in terms of allowances to hike it above the prescribed limit, more so, when the company is continuously suffering losses. Commander/ First Officer of Air India in both domestic and international sector are getting exorbitantly higher allowances as compared to their counterpart in domestic airlines and comparable international airlines. Scheduling of duties for pilots and cabin crew is currently done by Pilots themselves. This is not followed anywhere in the aviation industry as it may lead to favouritism, malpractices and conflict of interest.

6.5.10.6 Allowances/Performance Linked Incentives (PLI)

Pilots are one of the most important components of an airline industry. There is an acute shortage of type-rated pilots under Commander Category whereas co-pilots are available easily in the market. As a result, erstwhile Air India and Indian Airlines has enhanced the salary of the pilots by way of initiatives like PLI, Late Hour Allowances and other related allowances, so much so that PLI/other allowances constitute almost 75% of the total salary which works out to be 300% of the basic pay. “On an average, erstwhile Indian Airlines pilots, under Commander Category, gets around Rs.5 to 6 lakhs per month and erstwhile Air India pilots gets on an average Rs.7.5 to 9 lakhs per month exclusive of Lay-over allowance etc. Various allowances available to the pilots of erstwhile Indian Airline and Air India are as under:”

“ERSTWHILE INDIAN AIRLINES

S.No	Allowance(PM)	Remarks
1	Flying Allowance	Earlier Indian Airlines Pilots were given flying allowance as per actual flying. However, recently under an interim agreement of guaranteed 72 hours flying allowance is being given. The rate per hour ranges from Rs.2064-2704 for First Officer, Rs.2984-4088 for Captain and Rs.4470-5270 for Commanders .
2	Production allowance (fixed PLI)	It is given on fixed basis for each year of service and varies from Rs.16795-22565 for First Officer, Rs.27135-40455 for Captain and Rs.46085-72765 for Commander.
3	Experience	It is given to the Commander at a minimum of Rs.5000/- and

	allowance	maximum of Rs.12000/-.
4	Type allowance	It is given for a particular type rating at a fixed rate of Rs.4320/- for FO and Captain and Rs.5770/- for Commander.
5	A-320-Family Allowance	It is given to all the pilots at the rate of Rs.2300/- to FO, 6200/- to Captain and 10500/- to Commander.
6	Lay-over allowance	It is given to all the pilots at the rate of Rs.1600/- to FO/Captain and 2200/- to Commander for a minimum of 8 hours of stay in a hotel per night basis.
7	FDTL Extension Allowance	It is given to all the pilots at the rate of 150% of applicable flying allowance rate for the extended period.
8	SOD Flying Allowance	It is given to all the pilots at the rate of 65% of the applicable rate of flying allowance for SOD Travel for positioning.
9	Reimbursement	Reimbursement of meal/incidental expenses on international flight @\$ 60-75 per day.
10	Additional landing allowance	It is given for undertaking four landings in a duty cycle.

On an average, Pilots flying narrow body aircrafts are getting following total emoluments.

1. First Officer- Rs. 1,88,000 – 2,81,000/-*
2. Captain.- Rs.2,63,000- 4,17,000/-*
3. Commander- Rs.3,95,000- 5,67,000/-*

* *The emoluments does not include Staff on Duty (SOD) Travel Allowance, Lay over allowance, FDTL Extension allowance, Additional Flying Allowance for Hub and Spoke and Extra Landing, High Altitude Allowance and reimbursement on international flights etc.*

ERSTWHILE AIR INDIA

S.No	Allowance	Remarks
1	Flying Allowance	Air India pilots are given a minimum guaranteed 80 hours of flying allowance.
2	Layover subsistence allowance	A fixed amount net of taxes of \$ 2050 for Captains and \$ 1430 for Co-pilots is given.
3	CAT-III allowance	Co-Pilots Rs. 3000/month, Captain Rs. 5000 pm.

On an average, Pilots flying wide-body aircrafts are getting following total emoluments.

1. Co-pilot- Rs.2,10,000– 4,55,000/-*
2. Sr. Captain - Rs.5,95,000- 8,72,000/-*

* *The emoluments do not include transit check allowance; Lay over Subsistence allowance, CAT-III allowance and other benefits like PF and Gratuity.*

Executive pilots are getting following emoluments:

- 1 ED Level Rs.6,15,000 – 8,90,000/-*
2. GM Level Rs.6,10,000 – 8,85,000/-*
3. Addl. GM Level Rs.6,00,000 – 8,80,000/-*
4. Jt. GM Level Rs.6,00,000 – 8,77,000/-*

* *The emoluments do not include transit check allowance; Lay-over Subsistence allowance, CAT-III allowance and other benefits like PF and Gratuity.*

So far as the domestic aviation markets/sector are concerned airlines like Jet Airways, Kingfisher Airlines and Indigo Airlines are/were giving/given following allowances to their pilots.

On an average, Pilots flying narrow body aircrafts are getting following total emoluments inclusive of all allowances.

1. Co-pilot- Rs.2,14,000– 2,53,000/-
2. Sr. Captain - Rs.4,45,000- 5,00,000/-

Total emoluments being paid to the pilots, both under Commander Category and the Co-pilot category in the international and domestic market along with Air India are as under: -

(Figures in lakhs of Rupees)

Airline	Captain	Co-pilots/FO	
Air India (narrow-body)	3.95*-5.67*	Co-Pilots: 2.63*-4.17*	
		FO:1.88-2.81	
Air India (Wide-body)	5.95*-8.72*	2.10*-4.55*	Executive Pilots: ED:6.15*-8.90* GM:6.01*-8.85* Addl.GM:6.00*-8.80* Jt.GM:6.08-8.77*

Jet Airways (Narrow-Body)	4.49	2.29
Jet Airways (Wide-Body)	5.09	2.90
Indigo Airlines	4.25	2.80

Source: Market Source

** The emoluments does not include SOD Travel Allowance, Lay over allowance, FDTL Extension allowance, Additional Flying Allowance for Hub and Spoke and Extra Landing, High Altitude Allowance and reimbursement on international flights etc.”*

After several years of merger erstwhile Indian Airlines and Air India are following different parameters for determining PLIs to different category of employees, instead of common parameters. The parameters are not in tune with the industrial practices.

Both IA and AI have been giving PLI to its employees. Although it is not clear from the PLI formula as to whether it is Performance Linked Incentive or Productivity Linked Incentive. Muthukrishnan Committee was appointed to fix the criteria for PIL, but because of the death of the then Chairman of the said Committee, no final and conclusive criteria was determined. It seems that based on some loosely defined criteria under settlements and agreements reached between the Management and the Workers, PLI, at fixed percentage of pay was given to every one.

On behalf of Department of Public Enterprises, the decision of the two Managements of the two merged companies to give PLI was severely criticized. DPE stated it violates the DPE guidelines which are applicable to all Public Enterprises including the Government Companies i.e. AI and IA and the present newly formed company Air India formed on merger. AI had a separate PLI structure- introduced in May 1996 for technical cadre employees, but gradually it extended for other employees. Although an internal committee of AI (constituted in August 2008 to work out modalities for implementation of reduction of PLI/Allowance) had recommended (September 2009) reduction of PLI/Allowance ranging from 25 to 50 percent (yielding Rs.600 crores annually), this is yet to be implemented. Irrespective of the poor financial performance of Air India, PLI is being paid to everyone.

6.5.10.7 Medical and passage facility

Disparities exist between IA and AI on the quantum and quality of medical facility. There have been inconsistent and erratic free passage facilities being provided to in-service members of the staff in Ex. AI and Ex. IA. There are no clear guidelines regarding how many free passages can

be availed and how many members of the family can accompany the employee. Lack of proper instructions regarding free passage has resulted in misuse of the passage facility and causing undue strain on the finance of the company. Passage facility for in-service employees and retirees seems to be much higher compared to other domestic/international airlines.

6.5.10.8 Unions

The management –union relationship of AI is troubled which is often reflected in frequent strikes. The lack of rationalization and resultant non-harmonization of wage related issues had a negative bearing on the efficiency and productivity of the airline as a whole. Currently, there are several unions with several demands and interestingly both the companies even after several years of merger have their separate unions for same cadre. Inter-union rivalry is one major problem Air India is currently experiencing. The employees, represented by their respective unions, while still flaunting their outdated agreements of the 1970s have thus far refused to allow the management to change their work practices for making the airline customer friendly, so very imperative in today's competitive environment. Below a list of union/ association of AI and their main issues is being given.

From the salient issues raised by several unions and associations some common points can be made. It is evident that there is a strong sense of competition even after several years of merger between the employees of erstwhile AI and Erstwhile IC/IA. The employees of IC feel that they are being discriminated post merger. According to them AI employees have more benefits regarding pay scale, promotion, pension, PLI, etc., compared to them. If after several years of merger employees compete among themselves it is difficult to get an opportunity to leverage skilled and experienced manpower available with both the companies to the optimal potential. Another important point is employees have lot of concerns and demands regarding PLI scheme. The PLI scheme lacks transparency, so different group of employees demand different kind of benefits regarding PLI. The demands of some groups look illegitimate.

6.5.11 Role of management and Government intervention

Every time a new incumbent is appointed either as minister of civil aviation or chairman and managing director of Air India (AI), a statement one gets to hear is, “I will restore the past glory of Air India”. Even after over two decades, the reality is that all incumbents have left the national carrier in a state worse than before they assumed office. How else can one explain the perennial and consistent decline in AI’s fortunes, both financially and in terms of its market standing? Even the infusion of funds and induction of new aircraft have failed to arrest the declining trend. A mere expression of intent to regain the past glory, howsoever noble, can’t work. The fundamentals — political-free environment, a sense of commitment, work culture, to name a few — that helped AI achieve its glorious status in the 60s and 70s don’t exist today. To translate the intent, one must know what has gone wrong with AI and what needs to be done to cure it of the malaise.

The intervention of The Ministry of Civil Aviation over the functions of the management of Air India is excessive. This extreme intervention regarding every matter leaves very little room for any autonomy of the board. The government in its part must ensure real autonomy for the national carrier because as long as it is seen to be running the day-to-day affairs of the airline, the question whether AI can operate with its existing cost platform, the current level of revenues and an unbridgeable deficit will remain meaningless and the airline will always look forward to the government to receive monetary assistance for paying the employees, the vendors, etc. One would, in fact, like to advocate that a holistic view of AI's ability to survive in today's competitive environment needs to be taken by those who are conversant with the intrinsic and historical weaknesses of the national carrier and have a deeper understanding of the aviation business, rather than by bureaucrats with no experience and no accountability. It is important for the government to extend financial help to Air India, as the financial problem Air India is currently facing has been due to the government’s wrong decisions. Starting from appointment and termination of board members to formulation of major strategies such as merger or aircraft acquisitions, the government has been interfering in every matter of Air India.

If a company fails in all aspects and acquires losses year after year it is the task of the management to take important, corrective measures to bring the company out of the mess. As

the civil aviation ministry has been always intervening in the managerial aspects of Air India the responsibility of the ministry is more to take proper strategic, corrective steps so that the company can come out of the crisis, but unfortunately neither government as the owner nor the management has till date taken any effective and strategic measures. It is evident from the market share or profit and loss account of Air India, which is becoming more depressing by every passing year. It is important to arrest the structural weaknesses within the company. Ensuring efficiency, professionalism, proper management of resources, customer friendliness, arresting Industrial Relations problems etc., are some of the areas which need immediate attention, but the performance of Air India does not reflect any improvement in any area. Air India's performance is being monitored at various levels, thus it is quite surprising that why Air India is still not showing any modest improvement. Simple money infusion will not help the company to improve its performance. Structural changes like the reconstitution of the board, appointment of industry experts' not just IAS officers, working with the unions to stop them from going on strike every now and then etc., can help the company to improve. Since no such steps are being taken improvement of the company's performance does not seem to be happening any soon.

It can be affirmed with financial data that the decline in Air India's fortunes started with Mr V.Thulasidas at the helm. He was the chairman of Air India when merger was taking place. It did not take very long for Air India to go in red with virtually no check on expenses after V.Thulasidas became the chairman. Strangely, even as Air India ran out of cash to run the company he used all ploys to create an environment within the company that everything was good and the company was performing very well under his stewardship. To dress up the balance sheet, some of the owned aircraft were sold and leased back. In such an arrangement, the lump sum recovered through sale is shown as income, while the lease rental, generally one per cent of the aircraft cost, paid month after month is taken as expenditure.

As Air India had inadequate cash flows, loans were naturally availed of on a regular basis for meeting working capital requirements. By the time he demitted office in March 2008, Air India had almost exhausted the limit of Rs 14000 crore upto which loans could be taken against assets. Why was the actual financial state of the airline concealed? If only the real state of the

airline had been known earlier the corrective action could also have been initiated earlier. It is clearly a case of one man's personal ambitions taking a heavy toll of Air India. Incidentally, Thulasidas is the only Chairman in the recent past who has managed to not only complete his tenure but also managing to get extension. The last Chairman/Managing Director who managed to complete his term was Capt D Bose, who retired in 1987. All subsequent incumbents - Rajan Jaitley, Subhash Gupte, Y.C Deveshwar, Capt D.S,Mathur, Brijesh Kumar, Michael Mascarenhas, Sunil Arora, Raghu Menon either exited on their own before completing the term or were prematurely shown the door. It is apparent that Thulasidas even if he may not have managed the company well did manage the political environment incredibly well.

The performance of Air India was also being reviewed by Praful Patel and the bureaucrats of the civil aviation ministry periodically. How is it that they failed to "discover" the real state of the airline? This is also a subject matter that needs to be investigated in the quest for unearthing truth. Also answerable are the people who functioned as members of the Board of Air India. What were these Board members doing when the foundation of destroying Air India, was being mischievously laid, after all the public perception that Air India was being deliberately destroyed has been in the air for quite a few years now. With multiple systems to check misuse of authority existing, how could Thulasidas and company ruin Air India and get away with it so far?

Whilst there is a tendency to attribute all of Air India's current problems to recent decisions on aircraft acquisition and merger between Air India and Indian Airlines, which have undoubtedly hastened the southward journey, other problems extending from a poorly constituted Board of Directors, total lack of corporate governance, an indifferent management which has never been held accountable and the ministry's bureaucrats who revel in interfering in Air India's functioning on a day-to-day basis cannot also be overlooked.

Management biases were compounded by the ill-fated merger of AI and IC and have turned out to be one of the main reasons for the downfall of Air India. Specifically work related issues

have increased manifolds' post merger because of lack of proper attention. The differences in work culture, wage/salary structure, career progression policies in the two airlines were recognized even before the final call was taken on the merger. The merger was done in 2007 directly goes to V Thulasidas, the then CMD, and RK Singh, the then joint secretary, civil aviation ministry, besides Praful Patel as the then civil aviation minister, for not addressing to the HR problems with proper care that was going to take place post merger even though they had an idea of the consequences of HR-related problems. According to the CAG report, "During the discussions after the presentation (when the merger idea was being sold) apprehensions were expressed with regard to the HR problems arising due to merger. However, it was felt that it would be in the overall interest of both Air India and Indian Airlines to sort out these issues and work towards the merger under the guidance of the ministry" (Comptroller and Auditor General (CAG) report on Air India, 2011). It was understood even before the merger that HR problems will be massive and will affect the performance of the company, but still attention was not given and the company is paying the price. Even though the airline had Anup Srivastava as Director Personnel on the Board, he was, because of having an independent mind of his own, sidelined and the task of managing HR issues was entrusted by V Thulasidas to his juniors, on whom he had greater "faith". Arvind Jadhav, who was CMD in the period May 2009 to August 2011 went to more absurd lengths. He first entrusted the HR portfolio to the medical head of the company to set things right and later to a materials' management cadre officer, whose expertise lay in procurement of goods, not motivating men. This officer is currently undergoing a CBI enquiry. If pilots are up in arms today due to abject failure of the management to address parity issues since the merger took place, shouldn't V Thulasidas, the CMD of the airline at the time of merger and Arvind Jadhav be held accountable for their monumental failures, not understanding the gravity of the HR problems and leaving them unaddressed?

India does not have any national aviation policy. The ministry of civil aviation makes adhoc decisions to address different problems of the aviation industry. The adhoc nature of the decisions has been often harmful. Air India has been systematically harmed by different aviation policies. One important example is the policy related to Foreign Direct Investment (FDI) in the aviation industry. Until August 2012 FDI by foreign airlines in domestic airlines

was not allowed. In September, Government of India came up with a policy allowing FDI in aviation. Aviation as an industry is unattractive and the capital demand is very high. Most of the domestic Indian airlines are in need of extra capital. The decision regarding FDI was well received by the Indian aviation industry. Jet Airways was among the first to make use of the policy. After months of consultation with the top ministry for getting clearance, Jet finally succeeded to make a deal with Abu Dhabi-based Etihad. The deal was supposed to be beneficial for the aviation industry, but the liberal grant of 40,000 additional seats per week on the India-Abu Dhabi sector over a three-year period by the Government of India totally turned the nature of the deal. The additional seats were granted to Jet-Etihad at a time when already Indian aviation was facing the problem of over capacity and negative growth. This one decision made the entire aviation industry suffer including, Air India. Before the grant of additional seats, a meeting was organized by the Ministry of Civil Aviation with all the stakeholders of the industry. All domestic airlines, including Air India unanimously opposed the idea of additional grant of seats to Jet-Etihad. Ignoring the decisions of the stakeholder the ministry went ahead and granted the additional seats to Jet-Etihad. This gives rise to several questions and controversies what was the real use of the meeting? Was it just a ritual, if not, then why the ministry disregarded the unanimous decision of the stakeholders? One can always justify a decision, however dubious, by stating that the extra grant of seats is in the best interest of the customers, as the additional seat will enhance competition. The big question then becomes, was this the real reason for granting extra seats or there is something more to it, like helping an airline obtain a higher valuation. This is something which is impossible to know, but if the link can be established, it is nothing but insider trading which is punishable by law.

The ministry which granted extra seats to Jet-Etihad was the same ministry which forced Air India to buy extra long-haul aircrafts, using crores of tax-payers money. Now if, additional seats are being granted in a liberal way, then what is the national carrier going to do with its extra aircrafts? The aircrafts were bought to capture Indian aviation market. The idea was to get passengers from neighboring cities in India to fly to destinations in Europe and the US. In the changed scenario with extra seats being granted to Jet-Etihad, this will become impossible. The moment, Jet Airways begins operations from 23 Indian cities to Abu Dhabi for flying onwards (as per 6th Freedom Right) the entire market will go to Jet-Etihad. Another negative aspect of

this deal was, granting liberal rights to India-Abu Dhabi sector is bound to give rise to similar demands from other countries. What will the government do then? This one decision can make the survival of Air India even more difficult.

Air India today stands at the crossroads with some seeking privatization and others, mostly those associated with it or having nostalgic memories of its heydays, wanting an infusion of fresh life. With losses growing year after year; market share dwindling year after year, peoples' perception of the airline's image on the decline, the absence of a realistic turnaround plan on the anvil, the government, in its capacity as the owner, ought to take emergent note of the real state of the airline for corrective action, lest it is too late. The reality is that virtually every stakeholder - employees, the unions, the top management, the Board of Directors, IAS officers manning the Ministry of Civil Aviation, the politicians heading the sector must share the blame in varying degrees for having brought this iconic institution to a state of virtual bankruptcy. There is no denying the fact that Air India's fortunes have been on the decline for more than a decade now though the pace of descent for the worse has gathered momentum in the past five years or so. The regrettable part: the gravity of problems hasn't yet been fully recognized and hence no serious corrective measures have been initiated to improve the quality of the product.

Air India wouldn't have so many problems provided some correct decisions were taken by the ministry of civil aviation. Buying more aircrafts than required or could afford, surrendering profitable routes to private airlines and withdrawing flights from those routes, improper merger, very liberal grant of bilateral rights to foreign carriers are some of the decisions that have brought the company on the verge of collapse. The criticality of Air India's finances is now in the open, losing its market share month after month, registering huge losses year after year and not being in a position to pay employees their legitimate dues in time now that it is being compelled to curtail its flight schedule because it has no money to pay the oil companies for the fuel needed to operate flights. A pertinent question that begs an answer is: how much more deterioration should take place in Air India's performance before the government would like to sit up, take note and initiate corrective action to arrest the decline? The government's silence is making people question its intent, whether the government in its capacity as the owner is at all interested in ensuring the airline's survival. It is both shocking and unfortunate that the ministry

of civil aviation, the board of directors and the chairman continue to oversee and administer the company as if the current crisis is of an ordinary kind and that it will blow over with time without their having to do anything.

Air India was once India's foremost global brand. Today, it has ceased to be one. How did this massive decline take place, given the numerous checks and balances: the parliamentary committee attached to the civil aviation ministry, the standing committee of Parliament, the committee on transport, the committee on PSUs all meeting regularly and reviewing performance? Could not anyone among the over 200 parliamentarians on these committees sense that something was seriously amiss and that corrective measures were called for?

Likewise, the civil aviation ministers and secretaries also periodically review the performance of Air India. The big question is has these reviews served any real purpose? With so many watchdog institutions in place and Air India's performance under the so-called scanner, how has mismanagement almost ruined this iconic airline? It speaks volumes of the ineffectiveness of the review system of the parliamentary committees visiting PSUs to monitor performance.

6.6 Conclusion

Air India's vintage has either perished or are struggling to survive—a far cry from the days when these companies commanded leadership in their respective industrial sectors. This declining trend in their fortunes can best be attributed to an 'early-mover disadvantage'. Companies that have emerged in the last two decades have been found to be advantageously placed with regard to productive work practices, focus on customer, sound financial management, aggressive marketing strategies, etc. vis-a-vis companies of the earlier era because they have had their baptism by fire in the market place unlike the companies of yesteryear, which were born in a monopoly era, and therefore had policies and practices to suit the environment that then existed. What has led Air India to its current state? An apparent answer: failure of Air India to transform itself to face competition arising out of the opening of Indian skies in the nineties. Has Air India succeeded in re-engineering itself over the years for ensuring its survival in a competitive and changed business environment? 'No' would be the

obvious and emphatic answer. Besides being a victim of the ‘early-mover disadvantage’ phenomenon it also has all the drawbacks of being a government owned company. Private sector organizations enjoy relatively greater flexibility to adapt to emerging changes than a government controlled organization, like Air India. As a public sector undertaking, Air India has to work within the framework prescribed by the owners that are simply not conducive of efficient functioning. When a discerning customer looks for value for money, while buying a ticket, Air India can naturally not be his first or second choice and if a company can not feature as a top of the mind product it will undoubtedly lose out on premium passengers and revenue.

Air India can’t be allowed to become a laboratory for experimentation based on advisors with little or no knowledge of the airline. While one has heard a lot about attempts to trim costs, little has been made known about the plans to boost revenues. AI’s load factor (number of seats occupied in an aircraft), aircraft utilization and the yield (measured in terms of earning per kilometer flown) are among the lowest in the industry. Unless this trend is reversed, its finances will remain in a pitiable state. The management should monitor progress on these three key performance parameters, as they emanate from one single factor — passengers’ preference for an airline. As passengers will opt for AI in a competitive era only if it becomes an airline of choice, management needs to spell out as to what it has done to improve the product quality, which should be deemed synonymous with service. The performance of Air India in the past three years on key performance parameters has been so bad, that it has allowed smaller airlines to overtake AI, in terms of market share, on-time performance, etc. There is a mistaken notion that mere infusion of funds will help AI overcome the current turbulence. It won't.

It is clear that the management and the employees of AI have neither realized the gravity of the problem on hand, nor have they realized their role for the turnaround of the company. The government will therefore have to demonstrate that it means business by giving no concessions if AI falters in earning adequate revenues improve performance and is therefore unable to pay salaries to the employees. The persistent chant of AI employees that problems confronting the airline are not of their making must be put to an end once money is injected. In fact, with aircraft acquisition and merger, being cited as two main causes for the financial debacle, a large section of employees while finding fault with the government, and to an

extent with the senior management, are failing to see their own failure to deliver in terms of industry-level aircraft utilization, punctuality in flight operations, enhancement of revenue through aggressive marketing, efficient service to passengers at airports, etc. The government can not be accused of meddling in these key operational areas, where employees alone have had a role to perform. Some introspection by the employees is therefore imperative to ensure AI's survival, and thus their own, while an infusion of funds is taking place.

CHAPTER-7: CORPORATE FAILURE AND THE ROLE OF MANAGEMENT: A COMMENTRY WITH REFERENCE TO THEORY

7.1 Introduction

There has been a lot of research on organizational failure. Different researchers have defined the concept of organizational failure from different perspectives. Pearson & Clair (1998) defined organizational failures “as low-probability and high-consequence events” which is generally characterized by ambiguity. According to Seeger, Sellnow and Ulmer (1998) organizational failure is "specific, unexpected and non-routine events or series of events that create high levels of uncertainty and threaten or are perceived to threaten an organizations' high priority goals.” It is clear from the above definitions that organizational failure is a phase of uncertainty and functional crisis. In today’s corporate world organizational failure has become a common event. There is a fair amount of studies on different stages of crisis and recovery from corporate failures, but the relation between organizational crisis and ethics is still under researched. The role of business ethics becomes very relevant when an organization experiences failure or some kind of crisis. Ethical questions like the intent and the role of the management, wrongdoing, blaming, victimizing the stakeholders’ become most important in the context of organizational failure.

7.2 Role of management

Seeger (1998) observed that “one of the central features of organizational failure is the visible and active role of the management. The management is often designated as the failure spokesperson bringing authority and credibility to a highly equivocal situation.” Management

has the authority and the ability to deal with organizational failure. It depends on the management how it will present the moral tone of failure response in front of everybody. Management, for example, may accept responsibility where appropriate, take steps to stop exploitation of stakeholders and assure everybody that management will stop the occurrence of similar events in the future. On the contrary the more common approach that management takes is to blame each other, maintain ambiguity and mistreat stakeholders' needs. Lukaszewski (1987) points out that mainly there are two failure plans that management follows they are internal failure management plan and external failure management plan. The internal failure plan mainly deals with the functional failure within the organization like financial or marketing failure. The main focus of the internal failure management plan is to review the internal environment of the company. The external failure management plan helps the company to deal with media, public, investors and the entire external world. Failure often draws intense media attention, so it is the duty of the board to manage this attention in a way best suited for the company.

“As business environments change and grow increasingly complex, it is particularly important, that management develops a set of skills that will help them prevent and effectively respond to failure and other strategic issues” (Garcia, 2006; Mitroff, 2005). This involves identifying, planning and implementing the critical tasks and decisions required during a failure situation. Today information, true and false travels at a speed faster than light. The business environment is now connected globally. Good or bad, this is the environment in which companies operate. Thus, the way management deals with the crisis can make or break the image of the company. A strategic and well-planned response to an emerging failure is an important part of the entire failure management plan. The management needs to assure investors and other stakeholders' that the matter is being handled efficiently and in a timely manner

“Strategic choice gives attention to the active role of those groups who had the power to influence the structures of their organization. It led to a substantial re-orientation of organizational analysis and stimulated debate on three key issues: the role of agency and choice in organizational analysis, the nature of organizational environment, the relationship between organizational agents and the environment” (Child, 1997)

Following Child's definition one can say that the decisions and actions taken by the power holders of any organization constitute the process of Strategic choice. Strategic decisions are taken in relation to the environment within which an organization operates. It is done to evaluate the performances of the company and analyze the pressure of external constraints which also leads to the structure of the organization. According to Child (1997) "Strategic choice analysis incorporates both subjectivist and objectivist perspectives on organizational environment. This dualism does not only come from the subjective evaluation by the management of the environment as a critical link between its objective features and organizational action, though that is an important element in it. It also reflects a recognition that organizational actors do not typically, deal with an 'environment' at arm's length through the impersonal transactions of classical market analysis, but, on the contrary, often engage in relationships with external parties that are sufficiently close and long-standing as to lend a mutually pervasive character to organization and environment. The 'environment' contains cultural and relational dimensions in addition to the 'task' and market variables identified respectively by strategic contingencies and economic theories."

According to Song (1982) organization, is like a social order which adjusts itself through continuous negotiations. These negotiations are framed by structures within and without the organization. The concept of framing is being used to specify that there is a certain limit to the options and issues of negotiation. Although the actors involved in the process of negotiation can incorporate new options over time. Boekar, (1997) points out that the channels of information and formalized policies within an organization constitute the structures within the organization. "The strategic choice perspective in organizational analysis conceives of action being informed by the prior cognitive 'framing' of actors and of organizations in the form of embedded routines and cultures" (Boeker, 1997).

Action within an organization is bounded by the cognitive, material and relational structures. Actions of the agent are constantly repeated it becomes a part of the social process. Executives of an organization start strategic decision-making after examining the external environment and

internal conditions of the firm. Depending on the results of screening the manager formulates a set of objectives for the firm and decides on the strategy.

There is a debate among organizational researchers regarding the impact of external and internal environment on a firm's strategic choice. One set of researchers is of the view that the decision making within a firm is totally conditioned by external forces. The main proponents of this highly deterministic perspective come from diverse disciplines including industrial organization economists (Porter, 1979) and organization theorists (Adrich, 1979). The other set of researches emphasizes the role of internal control on strategic choices of the firm. This model, particularly talks about the role of management. According to this school, the internal environment of an organization largely depends on the value system and the perception of the management which in turn structures and implements strategic decisions. They also say since people make and run organizations, thus decision makers (management) have full control over the function of an organization. Child (1972), Mason (1984), Hambrick and Finkelstein (1990) are some of the important proponents of the internal control model. It is important to mention here, that the differences between the two perspectives are mostly superficial. Deep inside, they are more complementary than conflicting.

Some crises are preventable, some aren't. Most of the crisis starts just as a problem, but without proper monitoring turns into crisis. The key to crisis management is to understand the initial signals and immediately take corrective measures before it turns into organizational failure. Bergh and Johnson (2008) categorized crises in four categories:

- “Gradual emergence, external origin: These might involve economic downturns, the emergence of competitive threats such as breakthrough technologies, new go-to-market strategies, alliances of major competitors, or regulatory changes that limit business practices or expand competition.
- Gradual emergence, internal origin: Examples range from strategic mistakes (such as a poorly conceived merger) to failed product launches, the loss of key talent to competitors, and employee discrimination suits.
- Abrupt emergence, external origin: Some of the most obvious examples are natural disasters, terrorist attacks, and product tampering.

- Abrupt emergence, internal origin: This can include the sudden death or resignation of one or more key executives, failure of critical technology, production, or delivery systems, or workplace violence.”

There is no doubt that the natures of failure studied in previous chapters are gradual and have both internal and external origin.

7.3 Managers as agents

The crux of the corporate governance problem lies in the separation of ownership and control. With the rise of Joint Stock Company ownership became large and dispersed containing retail shareholders, institutional investors, promoter shareholders etc. In the changed scenario, it is practically impossible for this gamut of shareholders to take care of day to day management of the company. Thus a small group of professional managers run the firm, hence have control rights. This small group by virtue of running the company holds important information which the owners may or may not know. From the point of the shareholders' monitoring the managers are a costly endeavor. With lack of monitoring and privileged information the managers may not always act in the best interest of the shareholders rather they intend to run the company in their own interests. Managerial opportunism creates agency costs. It is the responsibility of the board of directors to make sure that the interests of managers and shareholders align. In executing these functions, the accepted norm is that the board of directors acts as fiduciaries of shareholders' and other stakeholders' interest. Researchers suggest that agency problems can be resolved through (1) optimizing risk-bearing properties of principals and agents, (2) increasing incentive alignment between principals and agents, and (3) effective principal monitoring of agents (Beatty & Zajac, 1994; Boeker, 1992; Mallette & Fowler, 1992; Tosi, Katz, & Gomez-Mejia, 1997; Zahra, 1996; Zahra & Pearce, 1989; Zajac & Westphal, 1994). Such agency solutions are successful only in developed markets and may not necessarily be effective in emerging economies. In addition to traditional agency problems, emerging economies have a unique set of agency problems.

While corporations with separation of ownership and control have dominated the US and the UK, cross-country studies have shown that there is a significant concentration of ownership both in developed countries (including the US and the UK) and in developing countries (La

Porta et al., 1998). In India, concentrated ownership and control is the rule rather than the exception. Under concentrated ownership and control, the nature of the agency problem is essentially different from that present in diffuse ownership structures. While in the latter, agency problems arise on account of shareholder manager conflicts, dubbed in the literature as Type I or vertical agency problems, in the former, agency problems arise primarily due to conflicts between the two categories of principals—the controlling inside shareholders and dispersed minority outside shareholders, dubbed as Type II or horizontal agency problems (Roe, 2004). Type I agency problems are likely to be alleviated under concentrated ownership and control as the incentives of controlling shareholders to monitor management would be stronger on account of their substantial stakes in the corporation. This, however, does not preclude Type II agency problems, of the incentives of controlling shareholders from seeking to extract and optimize private benefits for themselves at the expense of the minority shareholders (Morck & Yeung, 2004). For instance, owners of business groups in regions such as Asia, Latin America, and Continental Europe, by virtue of owning substantial family ownership, are directly involved in the management of companies in which they have controlling blocks, including as a part of the board of directors. This can give them large discretionary powers over a firm's decisions which can be opportunistically used to expropriate minority investors. The key difference in the nature of agency problem between promoters controlled firms and management controlled firm is that in the former the agents work only for one shareholder and in the latter the agents do not work for the shareholder (Parmer, 2004). The nature of Type II agency problem is what Perrow calls “owner opportunism” (chapter 2).

The role of ownership as a mitigating mechanism for agency problems first came into sharp focus in the context of alleviating Type I agency costs in widely-held firms and the lack of monitoring incentives for diffuse shareholders in such firms. Type II agency problem is often neglected. Two solutions to the monitoring problem in widely-held corporations have gained importance in the theoretical literature. The first one (referred to as the “alignment hypothesis” or the “convergence of interest hypothesis”) is to offer concentrated ownership stakes to the company management which would increase the overlap between ownership and control and help to align the interests of managers with those of the dispersed shareholders (Jensen & Meckling, 1976; Morck et al., 1988). The alignment hypothesis is less relevant in firms with

concentrated ownership and control where higher shareholding by controlling insiders can automatically help to align their interests with those of outside minority shareholders by strengthening the link between the value of the firm and the wealth of the insiders. In fact, in countries with weak legal and institutional frameworks, concentrated ownership is seen as a panacea for Type I agency problems, and at the same time is viewed as a commitment device that sends signals to outside investors that the controlling insiders will not divert corporate assets or engage in other forms of expropriation (Gomes, 2000; La Porta et al., 1999). The second prescription to ensure efficient monitoring to reduce Type I agency costs focuses on the positive role that outside blockholders with relatively large equity positions can play in reducing agency costs. Known as the “efficient monitoring hypothesis” (Berle & Means, 1932; Pound, 1988), its basic premise is that large outside shareholders in widely-held corporations are likely to be efficient monitors as they have substantial investments at stake, and the voting power to ensure that the investments are not lost (Fama & Jensen, 1983; Jensen & Meckling, 1976), and can alleviate the free rider problem associated with small shareholders (Grossman & Hart, 1980), and are in a stronger position to use the proxy mechanism to discipline inefficient management (Dodd & Warner, 1983). Moreover, block holders like investing institutions can engage in “relational investing,” and the presence of block holders like institutional investors can be socially beneficial as their interests tend to coincide with the interests of the society at large (Blair, 1995). Concomitant with the benefits associated with large block holdings in mitigating agency problems are the non-trivial costs as hypothesized under the entrenchment hypothesis, the conflict of interest hypothesis, and the strategic alignment hypothesis. Under the entrenchment hypothesis in the event of underperformance, insiders (by virtue of higher ownership and control) can successfully insulate themselves from outside disciplining forces such as from the takeover market or the managerial labour market (Demsetz, 1983; Fama and Jensen, 1983; Stulz, 1988). Under the conflict of interest hypothesis, conflicts may arise between outside blockholders and minority shareholders due to the pursuit of objectives by the former that are at odds with those of the latter. For instance, blockholders such as institutional investors usually hold diversified portfolios and so reducing firm-specific risk through effective monitoring may not be their concern (Blair, 1995). Finally, under the strategic alignment hypothesis, institutional investors who are outside blockholders, and managers who are insiders and often block holders themselves, can find it mutually advantageous to cooperate and act

against the interest of minority shareholders (Denis & McConnell, 2005). Strategic alignment between block holders and management and mutual self-protection are possibilities particularly when a block-holding institution sells something—a product, debt or financial services—to the company in which it owns substantial shares (Roe, 1994).

Some of cost and benefit studies of large shareholding done in the context of developed countries have some relevance to the Indian market, but some structural features of the Indian market make it somewhat unique. For example, some features of India market like a less developed capital and takeover market, the absence of a well developed managerial market, the greater importance of implicit trust-based contracting, and a generic tendency towards insider control make the governance problems of India very different from that of the developed countries (Sarkar & Sarkar, 2000). Khanna and Palepu (2000) also argue that monitoring by large shareholders in developing countries may not be as effective as in developed countries because of the poor availability of information on the performance parameters of firms due to inadequate disclosure norms and weak enforcement, the presence of political connections which make disciplining difficult, and the opaqueness associated with insider ownership arising due to pyramiding, crossholdings, and association with a large number of privately-held firms.

The cases discussed in the thesis are examples of companies having type II agency problems. Here the agents are the principals which lead to several other governance problems. The fraud angle becomes quite strong in this kind of scenario. In India broadly companies can be divided in three categories: 1. Public sector units, 2. Family run companies and 3. Multinational companies. The two cases discussed in the previous chapters are examples of PSU and family run business. In PSU Government is the majority share holder. In family run business the founder family is the majority shareholder and in MNC the foreign parent is the majority shareholder. In the next section governance structures of PSUs and Family run business is being discussed. The problems are being discussed in general. The cases studied in the previous chapters are no exception to these rules. In the beginning a larger attractiveness (using Porter's five force analysis) of the industries are discussed to give a picture of the external environment of the companies under study. As both the companies' discussed are unlisted thus the focus is on stakeholders not only the shareholders.

7.4 Porter's five force analysis

Micheal Porter is an industrial organization economist. Porter's five forces analysis is a framework which tries to determine the impact of five forces on the attractiveness of an industry. Depending on the attractiveness of an industry firms across the industry formulate their strategies. The "attractiveness" of an industry refers to the overall industry profitability. This framework gives importance to the external aspects of a firm. "The overall industry attractiveness does not imply that every firm in the industry will return the same profitability. Firms are able to apply their core competencies, business model or network to achieve a profit above the industry average. A clear example of this is the airline industry. As an industry, profitability is low and yet individual companies, by applying unique business models, have been able to make a return in excess of the industry average" (1979, Porter).

According to Porter the five forces which condition the attractiveness of any industry are threat of new entrants, bargaining power of suppliers, bargaining power of customers, threat of substitute products and rivalry among existing competitors. The collective strength of these forces determines the ultimate profit potential of an industry. Porter refers to these forces as the micro environment of an organization. He thinks these forces are more closely related to an organization and the impact of these forces on the organization is more direct compared to the macro environment. The role of the management is to position and formulate strategies for a company keeping in view how each force influences the industry. Knowledge of these forces of an industry provides the groundwork for a strategic agenda for action.

Threat of new entry of new competitors—After a new company enters to an industry it brings new capacity. The company tries to obtain market share and resources. This makes the industry unattractive. Higher the threat of new entry lower is the attractiveness of the industry. If the barriers to entry are high and newcomer experience retaliation from the competitors, the rate of entry of new competitors gets reduced. There are six major sources of barriers to entry they are, economies of scale, Product differentiation, Capital requirements, Cost disadvantages independent of size, Access to distribution channels and Government policy

The threat of substitute products- A certain industry produces certain products and services. If there are more substitute products or services available in the market then, the industry will suffer in earnings and growth. This will reduce the overall profitability of the industry.

The bargaining power of customers- Customers can force down prices, demand higher quality or more service, and play competitors off against each other-all at the expense of industry profits. A buyer group is powerful if: 1> the buyer is large. 2> the product it purchases from the industry is standard or undifferentiated. 3> the buyer, can reproduce the product or service. Consumers tend to be more prices sensitive for expensive products. The buying power of retailers is determined by the same rules, with one important addition. Retailers can get significant bargaining power over manufacturers when they can influence consumers' purchasing decisions.

The bargaining power of suppliers – Suppliers can determine the profitability of an industry by raising prices or by reducing the quality of purchased goods and services. A supplier group is powerful if: 1>It is dominated by a few companies and is more concentrated than the industry it sells to. 2> Switching suppliers for a customer is very costly.

The intensity of competitive rivalry- Rivalry among existing competitors manifests in the form of price competition, product introduction and advertising helps. Although it is very different to change the impact of competitive rivalry on an industry, but focus on selling in the fastest growing segments of the industry or in market areas with the lowest fixed costs can reduce the impact of industry rivalry.

Once having assessed the forces affecting competition in an industry and their underlying causes, the corporate managers can identify the company's strength and weaknesses. Where does it stand against substitutes? Where does it stand against the sources of entry barriers? Then the management can devise a plan of action accordingly.

Using Porter's Five Forces, the competitive dynamic as well as profitability and attractiveness of the retail and airlines industry is determined.

7.4.1 Retail Industry attractiveness

Threat of new entry of new competitors—It is not very difficult to enter the retailing industry. Bank loans are available for cash which can help in the inception and growth of an individual retailer. The critical aspect is to build and develop the required network with supplier for sourcing of goods and also to make customers aware of the new company. This poses the greatest challenge when it comes to barrier to entry.

The threat of substitute products-The alternatives available to a retail customer are mainly:

- Self-producing goods. The customers can self produce all the required items, but this is possible only for few products. A person can't produce everything he needs.
- Bypassing retailers. Customers can buy directly from the wholesaler. There are certain problems with this option. It is not always convenient or feasible for the customer to travel and buy in large quantities from the wholesaler
- Going to smaller shops.(kirana shop) This is a big threat considering a large proportion of Indian retail market is dominated by unorganized retailers.
- ***The bargaining power of customers***- In the short term customers have low bargaining power, as they buy whatever they find in the shop. In India there is a large unorganized market, thus switching costs for customers are not very high. This is a threat to organized retailers. In the long term retailers have to pay attention to what customers' want, as customers are their source of profit and income. Everyday the competition is becoming harder and harder, so satisfying customers are very important for the survival of any retailer.

The bargaining power of suppliers - Brands of the big manufacturers have huge market share in India. Indian customers feel manufacturers' brands are better than retailers' brands. Also penetration of private labels in Indian market is very low. Thus retailers have to keep products of popular companies. To do so retailers have to give up asking discounts to popular companies, this increases the bargaining power of the suppliers.

The intensity of competitive rivalry- In India, switching cost is very low because of the presence of the large unorganized retail sector. Unlike other industry brand value in retailing is not perceived by customers as something very important, especially for grocery and food retailing. Competitive rivalry in the retail sector is intense. It is mostly because of the presence of a large unorganized sector.

It is clear that in a place like India, where unorganized retailing is the rule for a first generation unlisted organized Retail Company (like the case) the external business or industrial environment is very challenging. It is now the work of the management to drive it steady in this challenging environment. The significance of Small and Medium Enterprises (SMEs) in the economic and social development of an emerging economy is immense. The most important features of SME sector are, the sector is populated by first generation entrepreneurs. The creativity and motivation of the entrepreneur is the key behind the growth of this sector. Contribution of the SME sector in the Indian economy is great. The SME sector has a huge impact on employment in India and comprises majority of the business of an economy. The economic landscape of India continues to be dominated by family firms. The case we have studied is a family run company (SME sector) in the next section we will see the internal governance challenges that family run business face.

7.4.2 Airlines Industry attractiveness

Threat of new entry of new competitors—The threat of new entry is low in airline industry compared to any other industry. There are several government rules and restrictions within airline industry, which poses a challenge for any new entry. Apart from that it is a highly capital and labor intensive industry which is a big barrier to entry.

The threat of substitute products- Substitutes facing the airline industry are other forms of transportation such as trains, buses, cars, etc. The threat of these substitutes depends on the distance to be covered, time required to reach the destination and cost. There is no other mode of transportation that compares to the speed of air travel. Also air travel is the most convenient mode of transportation when it comes to long distance travel. Cost of air travel makes it a less

attractive mode of transportation for short distance. Keeping all these in consideration the threat of substitutes is moderate.

The bargaining power of customers- The cost of losing one customer is marginal for the airline industry. This is because the airline industry is dominated by a large number of individual consumers. However, in an economic failure situation the decline in the number of passengers might change this perspective. From the customer perspective the switching cost is minimal. They can buy tickets online from any other airlines without incurring any additional costs. The consumers of this industry are highly price sensitive. They compare and contrast ticket prices before booking. For these reasons buyer power is at a moderate level in this industry.

The bargaining power of suppliers - This particular aspect poses the greatest threat to the airline industry. Most of its supplier e.g airplane manufacturer, airports, MRO (Maintenance, Repair, and Overhaul) service providers are mostly monopolistic in nature. Thus the bargaining power of the airline industry is very less and therefore is a threat to the company.

The intensity of competitive rivalry- Competition in the airline industry between current firms is rather concentrated. The increased competition with full service carriers mostly come from the low cost airlines. Since the customers are very price sensitive the popularity of low cost carriers is ever increasing. In India, compared to the full service airlines, the low cost carriers have more market share. Overall, the competitive rivalry is moderate to high.

Historically, airlines companies have made huge losses. It is very difficult to make a profit in this industry. The challenge of management is even greater in this industry compared to other industries. On one hand, it is extremely capital intensive industry on the other hand, it is structurally very unattractive. Management has to be very efficient and pro-active to keep a company afloat in the airline industry. Mismanagement of any sort can result in huge capital loss. The case studied is a government owned company. Government owned companies have unique governance challenges. In the coming section we will see some general problems PSUs face. Governance problems in a structurally unattractive industry can lead any company to failure.

7.5 Family Firms and Governance

Family firms have always been underrepresented in the literature. Researchers have mainly targeted widely held firms as their study topic. The reason behind this underrepresentation of the family firm is family firms are mostly small, privately held and unlisted. Getting sufficient data to study family firms is very challenging. It was also believed that the proportion of family firms was very less. Recent studies have managed to overcome the problem of obtaining data to some extent. According to some recent research majority of firms around the world are family firms where the founder or the founder's family is the majority shareholder. "La Porta et al. (1999) document that families control over 53 percent of publicly-traded firms with at least \$500 million in market capitalization in 27 countries. Additional evidence of the prominent role of families in large firms has been provided by Anderson and Reeb (2003a) and Villalonga and Amit (2006) for the United States; Morck et al. (2000) for Canada; Faccio and Lang (2002) for Europe; Claessens, Djankov, Fan, and Lang, (2002) for East Asian countries; and many others.... Family owned small firm constitute the major chunk among the unlisted firms across the nations in the world."(Baker& Anderson, 2010).

Corporate governance practices in unlisted small family firms in developing countries are very different compared to their counterparts in the developed economies. The difference between developed and developing markets in terms of societal structure, business ethics, entrepreneurial culture, resource scarcity, and regulatory environment make governance practices very different. Studies on governance problems of unlisted family firms in developing countries are very limited, although the impact of these firms on developing economies is intense. In a family firm the governance problem arises from the dyadic relationship between family and business. The simultaneous existence of family and business systems often forces the firm to compromise its economic objective over the non-economic one. Family firms often suffer from the problems of ownership transfers and management, conflicts of interest, issues surrounding kinship in management control and others.

7.5.1 What is a family firm?

The main features of family firms all over the world help to understand the governance challenges of these firms.

“A “family firm” is an organization that shares three common traits:

1. The founder or the promoter (blood or marriage) directly participates as the management and the board of directors.
2. The family owns a “significant” amount of shares in the firm.
3. Members of the family exert “significant” control rights in the firm, where the control threshold is at least as large as the fraction of ownership rights held.” (Baker& Anderson, 2010).

7.5.2 Agency problem in family firms

According to Jensen and Meckling (1976) information asymmetries are lowest in family firm, as the shareholder manages and controls the firm. According to them agency cost should be lowest in a family managed firm, as less monitoring is required to control moral hazards. “This claim is based on two assumptions: That owner management is an efficient substitute for the costly control mechanisms that non-owner-managed firms use to limit the agency costs of managerial discretion, and that the separation of ownership and control is the source of agency costs in firms” (Alchian and Woodward 1988). One can infer three reasons from Jensen’s and Meckling's (1976) model as to why privately held and managed family firms need not incur significant agency costs. First, in a family firm the problem of non-alignment of interest between the manager and the owner does not exist. A family firm naturally aligns the owner-managers' interests about growth opportunities and risk. This alignment reduces the opportunistic behavior of the managers, thus automatically the cost of monitoring opportunistic behavior gets reduced ergo agency cost is not incurred. Second, private ownership should reduce agency costs because property rights are largely restricted to "internal decision agents" whose personal involvement assures that managers will not expropriate shareholder wealth (Fama and Jensen 1983a, p. 332). Finally, family management should further reduce agency costs because shares tend to be held by ". . . agents whose special relations with other decision agents allow agency problems to be controlled without separation of the management and control decisions. For example, family members ... therefore have advantages in monitoring and disciplining related decision agents" (Fama and Jensen 1983b, p. 306). According to Jensen and Meckling agency costs are least in a family firm, thus it is the least costly (most efficient)

forms of organizational governance. In reality Family firm suffers from Type II agency problems. That is the problem between the minority and the majority shareholders.

Based on the theory developed by Becker (1981), Thaler and Shefrin (1981), Stulz (1988), and others, one can argue that private ownership and family management expose firms to “agency hazards.” For example, private ownership frees firms from the discipline imposed by the market for corporate control (Jensen 1993) and increases the agency threat posed by self-control. This agency threat comes from the fact that the owner-manager can also be motivated to take actions favoring his or her personal interest over the firm’s interest. Power is asymmetrically distributed in a firm. In a family firm owner- managers are more powerful, thus it is possible that an owner can engage in exploitative behavior with subordinates, in what Perrow (1986) refers to as "owner opportunism." In sum, it could be said that family firms do not reduce agency cost but changes the nature of agency cost. In a family firm, agency cost does not come from the exploitative behavior of the management, but it comes from the shareholders’ opportunistic behavior. Moreover, private ownership reduces the control of external governance and increases the self-control problems. If the owner-manager of the firm has no self-control and engage in unethical and exploitative behavior, external governance will be less effective to stop this kind of behavior. Finally, Family Firms also face an increased threat of adverse selection, as most of the time; kinship gets preference over efficiency in family firms. All these create “agency hazards” which is nothing but a different type of agency cost.

7.5.3 Governance problems of family firms

Starting with the seminal work of Becker (1981), many have viewed families take decisions that maximize the welfare of the family. Family businesses, suffer from the problem of majority-minority shareholder problem. This problem comes from the conflict of interest between the controlling majority shareholder and the non-controlling minority shareholder. In a way it is a kind of principal-principal problem. In the case of Subhiksha major conflict of interest took place between Subhiksha’s promoter and controlling shareholder Subramanian and the institutional minority shareholder ICICI-Venture Capital. The central objective of

family-firm governance research is, therefore, to understand how freezing out minority shareholders takes place and how can it be stopped. The quality of minority investor protection regulations in India is not very strong. The problem of quality has more to do with the implementation of the regulations rather than their existence. “India does rank at par with most of the developing countries as far as the quality of the regulations are concerned, however strength of the agencies institutionalizing these norms are debatable” (Rajesh Chakrabarti.2005).

Board composition

A Lot of research has been done to understand the relation between board composition and firm performance. The role of the board in a family firm is a very important aspect of the governance structure of a family firm. The board in a family firm is very closely held and the promoter becomes the most important member of the board. The promoter controls and rules the board. The existence and selection of the board also depend on the promoter, so in a way the board of family firms exists for namesake (Bhagat et al., 2008; Dalton et al., 1998; Dalton et al., 2008; Walsh & Seward, 1990; Goyal, V.K., Park, C.W., 2002, Brunninge and Nordqvist, 2004, Cowling, 2003). However, there are a number of SME boards that exemplarily use the boards for strategic decision-making (Feigner, 2005). Governance researchers suggest that appointment of more independent directors on the board ensures better governance practices. Independent directors are expected to give more importance to the interest of non-controlling shareholders. In a family firm where the selection of independent directors is dependent on the large promoter shareholder how far independent directors can work independently is debatable (Morck et al. 2004). Similarly, the market for corporate control may not discipline managers when they themselves are the large owners.

The Subhiksha board was a classic example of a promoter controlled board. The board of Subhiksha was extremely autocratic. Subramanian as the promoter shareholder used to take all major decisions for example, decide to expand Subhiksha, plan to merge Subhiksha with Blue Green Constructions in spite of board opposition, low cost strategy implementation etc. The autocratic nature of the board becomes clear when the company started to experience financial problems. The board was kept in the dark about the company’s actual financial position till

November; 2008. At the board meeting held on November 22, 2008 the management was questioned on the financial aspects, including the inventory positions of Subhiksha. In this meeting the management admitted for the first time the seriousness of the problems. The board then asked Subramanian to submit the audited account of Subhiksha starting from April 2007 till November 2008. The board also directed the promoter shareholder to appoint KMPG for an independent review of accounts, appoint a CFO and complete the audit of accounts before December 31, 2008. The chairperson of the board meeting afterwards confirmed that the management did not implement any of the decisions.

Control issues

In a family firm control rights form a major part of governance problem. The conflict of interest regarding control rights comes from the promoter and controlling shareholder and the non-controlling institutional shareholder. On one hand, owning more shares give the promoters control rights. On the other hand by virtue of being large institutions, institutional shareholders are more active to protect rights compared to retail individual shareholders. In the case discussed we can see that the same has occurred. There was a strong conflict of interests between Subramanian the founder and MD (controlling shareholder) and ICICI-V (non-controlling shareholder). ICICI-V accused Subramanian as he was the controlling shareholder for keeping the investors in dark regarding several financial matters of the company. Although latter when he was accused of forgery, he denied his responsibilities as the controlling shareholder and pointed out ICICI-venture was the controlling shareholder.

In terms of control rights, the literature has emphasized that “control matters in settings of contract incompleteness” (Williamson, 1985). Due to incomplete contracts, majority shareholder can strategically invest in value destroying projects (Shleifer and Vishny, 1989). Similarly, ex-post bargaining may be affected by, for example, free-rider problems (Grossman and Hart, 1980) or wealth constraints (Aghion and Bolton, 1992). Control becomes the most important factor in family run small unlisted firms. In the case we have seen I-Venture was the institutional shareholder, but all throughout the control of Subhiksha was concentrated in the hands of Subramanian as the founder of the company. Afterwards as an institutional investor

ICICI-Venture took some actions like doing independent inquiry of Subhiksha's inventory position, asking The Registrar of Companies to look into the books of Subhiksha etc.

Financial Mismanagement and Fraudulent behavior

Family firm is one where members of the founding family continue to hold large shares in the company and enjoy control rights. "Shareholders in controlling position do take measures to enhance firm value. However, with control enhancing mechanisms in place, family firms may consolidate their ownership position by creating sister concerns and siphoning resources away from the firm in favor of their sister concerns" (Chen, et al. 2007). Following complaints from ICICI-Venture on financial mismanagement, The Registrar of Companies in Chennai started inspecting Subhiksha's books, only to find out that Subhiksha was constantly diverting money to several shell companies. Paper companies were set up to manipulate accounts and siphon money and transactions with related parties were not disclosed.

Altering financial data, misrepresenting performance are some of the strategies family firms often use. Researchers have discussed various motives behind altering financial reports like "...mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend upon reported accounting income numbers" (Healy & Wahlen, 1999). The discretionary accounting choices are used by managers for better signaling about the financial performance of firms. Firms controlled by the same family often obtain goods, services, or financing from each other, which gives rise to several other ethical and governance challenges. Subhiksha was linked by the investigators (RoC) to at least 42 shell companies which it suspects were used to route bank money. Another eight companies also appeared to have been floated by Subramanian. Subhiksha used to buy most of its grocery items from these companies. All the companies were linked to each other by common shareholders and all of them hold shares in other companies, forming a complex matrix making it difficult to unravel who was ultimately controlling the company. All these companies had common directors, common shareholder or share addresses. Subramanian diverted bank funds to many of these shell companies and hid the fact by inflating Subhiksha's revenue, profits and inventory in order to give the impression of growth. For instance, Stone N Sand Builders, Sun N Sand Tours and Shevaroy Holiday Resorts all have a share capital of 5 lakh, a share premium

of 5 lakh and investments of 5 lakh in each other. It was seen that no amount was received by any of these three companies towards share capital and share premium and no amount was paid by any of these three companies towards investments in these companies and possibly there may be only book entries, which is a very serious matter. Zash investments afterwards accused Subhiska for signaling this wrong information which prompted the company to buy stocks and invest in Subhiksha just before Subhiksha stopped all its operations, leaving the investment company to hold dud stocks.

There have been essentially two sources of evidence across countries on minority shareholder expropriation—the first, an examination of individual cases following corporate collapses or due to allegations of complaints made and cases adjudicated, and the second, large sample empirical studies attempting to examine whether such expropriation exists via the various mechanisms of tunnelling. The present study is a modest attempt of the first kind. With regard to the first, specific cases of diversion of funds have been identified in recent years under the control of the Serious Fraud Investigation Office (SFIO) set up by the Government of India in 2003 to investigate financial frauds that involve public interest substantially either in terms of monetary misappropriation or in terms of persons affected (under the limits of the Companies Act, 1956). The case studied here is been investigated by SFIO. Between 2003 and March 2010, 767 cases of misappropriation and diversion were filed with the SFIO against 31 companies. An examination of the nature of select cases under the SFIO based on information available in the public domain show that company promoters were in large part alleged to be instrumental in diverting funds and defrauding minority shareholders through various means.

Apart from cases investigated by the SFIO, cases of shareholder oppression, mismanagement or apprehension of mismanagement of the company are adjudicated by the Company Law Board (CLB) in India under Sections 397/398 of the Companies Act, 1956. With regard to the second source of evidence on the extraction of private benefits of control by controlling shareholders in India, there are only a few large sample studies which have empirically tested for minority shareholder expropriation especially in business groups.

7.6 Governance of Public Sector Units (PSUs)

The growth of Public enterprises in India has been varied and complex. They are generally set up as government companies or statutory corporations, wherein the respective functions of government, parliament, and the enterprise are specified. The objective of providing this form of organization is to make them independent of the normal governmental machinery and to provide them with the necessary autonomy to operate like any other business or commercial enterprise. The case studied here is controlled by the ministry of civil aviation.

7. 6.1 Development of PSU governance

The management of PSUs in India rested in the hands of the concerned parent ministry (Ministry of Civil Aviation controls Air India). The idea behind the ministry managing PSUs was Public sector enterprises were developed by tax payers money that is public money so it requires more scrutiny compared to any private company. Because of this idea when the PSUs were first set up apart from the ministry the performance of the public companies were reviewed by the parliamentary committees and other constitutional bodies like the comptroller and auditor general of India. The performances of PSUs were reviewed more rigorously than private enterprises. By 1970s, PSUs started reporting sickness and management failures, so more specialized, professional and technical managerial knowledge became indispensable for the revival of the Public Sector Units. It was felt that a certain amount of board independence was important for efficiently running a public company. In 1972, the Bureau of Public Enterprises recommended for the position of a Chairman cum Managing Director along with a part-time director for overseeing the operations of the PSU Board. Autonomy was given to Chairman cum Managing Director. After this step was taken, in 1975 the Administrative Reforms Committee suggested to include non-government individuals on the Board to ensure further independence and efficiency for the PSUs.

With liberalization in 1991, the importance was given to efficiency of the PSUs. PSU reforms were targeted to gain better board independence so that they can become more competitive. Post liberalization markets were also reformed, which lead to the creation of the market regulator SEBI (Securities and Exchange Board of India). SEBI through clause 49 enforced

certain governance guidelines that were applicable to all listed corporate companies. These guidelines were previously suggested by the Birla Committee in 1999. SEBI guidelines gave importance mainly to board independence through independent directors and their codes of conduct, financial disclosure and auditing. The recommendations of SEBI were applicable to PSUs as well. Looking at the developments in the governance of PSUs Dewan (2006) suggested that in “pre-liberalization reforms suggested a separation between the owner and the controller, i.e., the government and the board, respectively, the post-liberalization SEBI guidelines suggested a balance of power between the insider, i.e., the executive chairman and the outsider, i.e., the independent director” (Dewan, 2006). Ministry of Company Affairs along with its own committee and Irani committees tried to revamp the Companies Act of 1956 which was the primary basis of governance for all public companies. The recommendations of this Committee became the basis for the Voluntary Guidelines on Corporate Governance for Central Public Sector Enterprises (CPSEs) which were released by the Department of Public Enterprises (DPE) in 2007.

These Guidelines on Corporate Governance for CPSEs were mainly influenced by the governance guidelines proposed by SEBI for private sector companies. The SEBI guidelines in turn closely follow international, specifically US and UK corporate governance norms. Thus, the corporate governance codes of India are heavily influenced by the Anglo- American developments like the Sarbanes-Oxley Act. Like SEBI, the DPE guidelines cover issues related to the Board and independent directors, audit committees, disclosures, ethics and code of conduct, risk management and reporting. The question is how far a governance code influenced by the codes of developed market; cater to the governance needs of PSUs in India.

The governance problems in the western world are mainly concerned about disciplining the management. The governance codes and ethical standards in the west mainly focus on norms to make the management refrain from unethical behavior and make the management more accountable, transparent and responsible to the owners. The governance problems are influenced by type I agency problem. The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders. “A board which is accountable

to the owners would only be one which is accountable to the dominant shareholder; it would not make the governance problem any easier to solve” (Verma, 1997). Continuing further, Varma adds, it is possible for shareholders to make the management more accountable, by properly monitoring the board or by electing independent directors. It is impossible for a board to stop the oppression of the minority shareholders’ from the dominant shareholder because the appointment of the board is decided by the dominant or the majority shareholder.

7.6.2 Governance problems of PSUs

Board independence

There has been an extensive emphasis on Board independence by having independent directors on the Board. The governance codes even have guidelines to penalize PSUs which fail to have such independent directors (even though their nomination is to be made by the government). The accountability of a PSU board towards its stakeholders’ is much more compared to any private enterprise. Every tax paying citizen of India is a stakeholder. In such a context board independence becomes every important keeping in view the efficiency function of a PSU. It is difficult to ensure efficiency without board independence and without efficiency; it is difficult for a company to be financially and operationally stable. Since, public money is invested in a PSU financially and operationally dysfunctional companies can end up wasting a lot of public money (Bhattacharya, 2006; Sinha et.al., 2010).

One of the biggest myths perpetuated over the years is that our PSUs, including Air India, enjoy full autonomy in their day to day functioning. If Air India’s survival has to be ensured, it should be the management of Air India, operating out of the Air India building at Nariman Point, Mumbai, taking decisions and not Rajiv Gandhi Bhawan in Delhi, which currently takes decisions on all major issues without a shred of accountability. All key decisions—merger, aircraft acquisition, frequent change of CEO, etc—responsible for Air India’s current travails were taken at Rajiv Gandhi Bhawan. In fact, the two parliamentary committees—the Standing Committee on Transport, and the Committee on Public Undertakings, —have criticized the civil aviation ministry on aircraft acquisition and merger, describing them as two main issues responsible for Air India’s huge financial losses.

Power-dependency relationship

Power as a dimension in inter-organizational relations is a very important factor but yet less emphasis has been given to power in the context of inter-organizational relations. Power becomes an important dimension in relations between organizations based on mutual dependence. Here "power," means the ability of one element (subsystem) in the system to determine the actions of another element or the ability of the enterprise to control dependency on elements of the enabling system. In other words, power is the dimension for controlling dependency; thus, there is emphasis on the role of power-dependence in understanding the nature of exchange or relationship between the enabling system and a public enterprise.

In order to function systematically an organization has to depend on several other subsystems which constitute a complex power network. Most often there remains a certain asymmetry of power between the subsystems which could result in dysfunction. A brief description of the various organizations and the type of relationship formally envisaged would clarify the asymmetrical interdependence and the overlapping roles. Various public enterprises are directly controlled by a department of the government on the basis of functional relationship. This department, which we refer to as the parent department, is responsible for the ultimate functioning of the enterprises under its jurisdiction and is accountable to Parliament through the respective Minister. Now this parent ministry interacts with other ministries for its smooth functioning like ministries responsible for finance, labor, industry, etc. The ultimate control and accountability is exercised by Parliament which has its own Committee on Public Undertakings. This network of relationships that a public enterprise has to enter into with other agencies provides a framework to understand the inter-organizational dynamics. A significant role is assigned to the parent- ministry which is responsible to Parliament for the overall performance of a public enterprise under its jurisdiction. In order to fulfill this role, it is authorized to: (a) constitute the board of directors of the enterprise; (b) issue policy directives; (c) hold power of approval and sanction, and (d) have right to information. One of the mechanisms adopted by the ministry to effectively exercise this authority is the appointment of officials of the parent and finance ministries to the boards of these enterprises. Though the objective is to coordinate various interests, in reality, it amounts to penetration. The officials

who are also board members adopt two roles: as board members, they are a part of management; and as representatives of the various ministries, they carry out the controlling function of the ministry. Under conditions of asymmetrical interdependence, such a mechanism can lead to conflict arising out of clarity of goals and the methods of goal attainment. For example, the Ministry, because of its responsibility to Parliament for the overall performance, may adopt various methods of control to check on an enterprise's performance, while such control is seen by the enterprise as curtailing the autonomy it needs for effective performance. Such conflicts can become acute if there is a difference in orientation between officials of the ministry who are career-bureaucrats and executives of the enterprise if they are from a business and industrial background. This is something we often get to see in Air India. Since the board of AI is selected by the ministry of civil aviation the existence of the board depends on the ministry. All crucial decisions are taken by the ministry via the board for example, aircraft acquisition, leasing out of aircrafts, equity infusion, and bilateral rights and so on. Very often we get to see civil servants serving AI board and their tenure is fixed so instead of taking any pro-active measures they prefer to go with the ministry to complete the tenure. If people from business and industrial background join as a board member of AI and objects to the ministry's decisions they either are transferred or fired.

Apart from the transaction the enterprise enters into on its own with other agencies and ministries, the parent-ministry plays an important mediating role in enlisting support from the various agencies on behalf of the enterprise. In addition, both the parent-ministry and the enterprise interact with agencies like the Audit Boards and the Committee on Public Undertakings, which undertake evaluation of public enterprises as and when required and report to Parliament. Similarly, the Bureau of Public Enterprises (now a part of the Cabinet Secretariat) and the Ministry of Finance are also involved in this relationship vis-a-vis a public enterprise, thereby adding a new dimension to the power structure in the inter-organizational network. As a PSU Air India has to maintain this kind of complex inter-organizational network. The performance of AI is measured by several agencies at the same time for finances AI has to depend on ministry of finance. This brings in several confusions first of all different agencies evaluate the performance of the company based on different parameters. Secondly, often it becomes a problem for the company to follow different guidelines given by different

agencies. Some examples from Air India can clarify the situation. When AI was acquiring aircrafts the process was very lengthy the obvious reason was it had to take permission and follow directions from several agencies which were at times confusing and contradictory. Another example would be the guidelines AI follows regarding salary and incentives. AI does not follow the DPE guidelines, but being a PSU it is expected to follow the DPE guidelines. The DPE guidelines are very different from AI's own guidelines which are currently creating lot of confusion.

The network of relations between an enterprise and the enabling system at any point of time can be either dyadic, or triadic. Examining the nature of outcomes, it is likely that the enterprise and the parent- ministry are likely to act jointly (as the existence of the board of the enterprise is dependent on the parent ministry) against any one of the evaluating or controlling agencies (Audit Boards, The Department of Public Enterprises, The Committee on Public Undertakings and the Finance Ministry). In addition, one has to take into consideration conflicts arising out of values, personalities, and the knowledge of the existence of other agencies within this network.

The dynamics of the power-dependency relationship would largely depend on whether public enterprises have clear specified goals and proper assessment systems. It is also very important to have a certain amount of board independence for assessing performance. This has to be examined in relation to the social system within which the enterprise operates. The fundamental issue, then, is whether in India there is an institutional framework which is capable of producing the managerial manpower to exercise the type of discretion required for operating complex industrial enterprises. This results in a tendency for organizations to be centralized, bureaucratic, and inflexible. Naturally, when managers lack discretionary ability, they tend to refer matters to higher authorities and to adopt a failure-avoidance approach. This is likely to be accentuated with the type of investigations of the enterprise by audit and legislative bodies set up to uncover illegalities and incompetence. Another contributing factor is the continued appointment of civil servants to top management positions, for they, by their very training, are reluctant to take the necessary risk and initiative. Thus, managers of public enterprises in India generally avoid taking risk and initiative.

One can easily state from the case that Air India's fast-paced decline in fortune in recent years has taken place when it has been headed by IAS officers- a mere coincidence or poor leadership, one can't state with a fair degree of certainty. What can, however, be said with full confidence is that most of such chairmen thrust on the airline from outside have failed to take the employees along, not believed in teamwork but preferred to work with a group comprising select officers, largely been autocratic in their dealings, showed no sense of commitment and have been more subservient to political leadership. Significantly, they have seen their tenures of limited term as any other job in their career with no stake in the organization they are heading and thus failed to protect the interests of the airline, where and when it mattered most. The managing directors who emerged from within the organization were known for resisting orders from the Ministry of Civil Aviation but the fate of these managing directors have resulted in either termination or transfer. The ultimate power of control lies with the political element, but the effective power of control has been appropriated by the bureaucracy in India.

Multiple objectives'/ principals' problems

In the private sector, the management has to follow only one objective that is to make profit. In the public sector a company has multiple objectives, both economic and non-economic. Stiglitz, (2002) argues that this sort of ambiguity and vagueness of objectives in public sector create serious agency problems. The ambiguity of objectives gives the managers of a public sector unit the scope to pursue their own interests. Managers of public sector unit can always claim that the company is losing money not because the management is inefficient, but because of the burden of non-economic objectives. It is virtually impossible for an outsider to judge the validity of those claims. This in turn leads to very serious agency problems. This is one problem which can't be solved with more internal control. Even if managers want to give his best it is impossible to perform efficiently given the fact that these objectives are often contradictory. Adams (1996) dubs it as the "Hydra factor" (discussed in detail in chapter 2). As we have seen in the case that several times, the losses faced by the company are attributed to several social obligations that the company has to perform being a PSU. For example, flying to unprofitable routes like the north-east and other remote areas, undertaking special operations as

a social obligation for e.g. special flights were operated to evacuate Indians during the Gulf war etc.

The governance challenges unique to PSUs arise “because of its ‘state ownership’ and ‘national interest’ and the ambiguity of these entities. Organization for Economic Cooperation and Development (OECD) acknowledges this need and suggests that the government should develop and issue an ownership policy that defines the overall objectives of state ownership, the state’s role in corporate governance of PSUs” (KPMG, 2010). The same problem of objective can be seen in the case studied. The foremost action that needs to be taken by the government, in its capacity as the owner, is to redefine Air India’s role after being convinced that it wants the national carrier to survive. Should Air India function as a commercial airline like other private carriers (giving importance only to profit) or differently (carry the burden of social objectives)? If Air India is not to be allowed to operate on commercial lines, comparison with private airlines on various performance parameters must stop. Such unwarranted comparisons take a heavy toll on the company’s image and morale of employees. There are numerous government policies that render Air India at a disadvantage in comparison to private airlines, viz., being accountable to over a dozen parliamentary committees—on, which several hundred hours of top management time are spent annually; adherence to government policies and procedures, which besides being time consuming also come in the way of selecting the best, etc.

Edward Freeman, who is the most important proponent of stakeholder theory remarked: “My thesis is that I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to shareholders with the concept that managers bear a fiduciary relationship to stakeholders. Specifically I include suppliers, customers, employees, shareholders, and the local community, as well as management in its role as agent for these groups... Each of these stakeholder groups has a right not to be treated as a means to some end, and therefore must participate in determining the future direction of the firm in which they have a stake” (1984). From the perspective of agency theory, this gives rise to an obvious objection. As Frank Easterbrook and Daniel Fischel write, “A manager told to serve two masters (a little

for the equity holders, a little for the community) has been freed of both and is answerable to neither.” (1991).

Holding managers accountable to the interests of different groups can create a serious multi-principal problem. The problem lies in the multiplicity of principals as different principals evaluate performance from different perspectives and hence confuses the agent (public enterprise in our case) with a huge list of requirements which are often inconsistent with one another. In India, there are too many controlling agencies and yet there is very little control. There is the planning commission, the parliament, the auditor general of India, the Bureau of Public Enterprises (BPE) and each public enterprise is required to publish its financial statements annually under the Indian Companies Act which is enforced by the Registrar of Company Affairs. Each of the above monitoring agencies has a slightly different concern. While the Planning Commission may be concerned with overall social welfare, the auditor general emphasizes propriety, and the annual reports look at conventional financial measures of performance. Thus it is more than enough to create an environment of total confusion for the manager regarding which principal they are actually serving.

7.6.3 Cost of being a PSU

There are several problems with using private profit as a criterion for public enterprise performance, as the cost of social welfare is an extra cost for a PSU. Public enterprises are formed based on public policy. Thus the operation of any public enterprise has to bear the function of social welfare. One of its objectives is to enhance social welfare. To determine whether a public enterprise management has enhanced or hampered social welfare, a criterion must meet the following requirements: (1) It must be only related to factors within the control of the enterprise manager. In other words, it must be 'fair' to the public enterprise management. (2) It must be monotonically related to social_welfare.

In several situations, a PSU has to bear extra costs compared to any private enterprise just because it's a PSU. This point can be illustrated from the case studied. Air India, often bears the extra cost for the structural formalities, it is mandated to follow as it is a PSU. The example

of leasing policy of Air India can illustrate the point. Air India was supposed to lease three Boeing 777-300ERs to Thai Airways and three Turkish Airlines. The thumb rule of the airline industry is the leasing company receives one-hundredth of the aircraft cost as monthly lease rent. Easy calculation would reveal that the monthly rent for six aircrafts' would be somewhere between Rs 325-375 crore. This amount of money could have helped a company like Air India to some extent considering its disastrous financial position. The problem is Air India lost this opportunity to Jet Airways because of the time consuming procedural formalities. Air India as a government company has to follow certain procedures before leasing any aircraft. The process: first obtain an in-principle approval of the Board; issue a global tender notice inviting bids; scrutinize the bids; hold negotiations with the highest bidder; seek approval of the Board — a time-consuming process, by the end of which the interested airline has invariably explored other options. On the other hand, private airlines, with no queries from the Comptroller and Auditor General, the Central Vigilance Commission and numerous Parliamentary committees to answer, can settle the leasing rate through negotiations held across the table. No one can, however, be held accountable for this loss because it was the system that caused this loss.

The Committee of Secretaries, which is engaged in the exercise of ensuring Air India's survival, needs to adopt a very pragmatic and pro-active approach so that Air India can function as a commercial airline. It is also equally important to look that decisions are being taken much faster unlike now. Air India operates in an environment where it is difficult for it to function on purely commercial lines. Air India has to take care of the restrictive and time-consuming rules and regulations that have failed to serve any fruitful purpose, but which have hurt the airline.

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CHAPTER-3 AND CHAPTER-4

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Synopsis

Introduction

Companies today are in the forefront of creating social wealth. The survival and success of a firm depend upon its innate strength-the resources at its command, including physical resources, financial resources, skills and organization-and its adaptability to the environment. The impact of the business environment on any organization is very deep and intense. Business environment consists of different factors broadly classified as external and internal factors. Business environment can be classified into two major categories: the external environment and the internal environment. The internal environment comprises physical and social factors within the boundaries of a firm; the external environment comprises correlating factors existing outside the boundaries of the firm. The external environment is comprised of political, socio-cultural, economic, ecological, and technological categories, while the internal environment comprises customers, suppliers, competitors, and regulators

Literature on the influence of environment on business strategies is conflicting in nature. Some studies give importance to internal factors more than external factors while there are other studies which prefer external factors over internal. Although different studies give importance to different factors, but almost all studies agree that both internal and external factors play a role in the strategy formulation process.

Several studies on corporate failure suggest that management (including directors responsible for the overall management of the corporation) is the source of most problems initiating corporate failure. As stated above the business environment consists of suppliers, customers, investors' etc. they are the prime stakeholders of any company. The way the management deal with different stakeholders of the company influence the growth or failure of any company. The role of the management is to strategically deal with the company's stakeholders and position the company accordingly. The skill and motivation of the top management determine how a company is going to adjust against its internal or external environment. It is the duty of the management to formulate financial, strategic and overall corporate policies. Thus, understanding the role of management becomes an important aspect of the present study.

Context

The context of the study dates back to 2007-2008. During that time the global business environment was impacted by the heat of recession. India too felt the heat of recession. In India the effect of recession was felt in sectors such as banking, share-broking, retailing and air travel. It was in this context of turmoil in the external business environment, this present study made an attempt to understand particular cases which are/were trying to adapt to the rapidly changing business environment. Two companies have been studied one from the aviation sector and other from the retailing sector.

Objectives

The main objectives of the present study are:

- The main objective was to study how managements (agency) of business organizations perceive, understand, plan and implement strategies and policies and restructure organizations in a time of organizational failure and attempt to come out of the crisis. Whether the failure is primarily due to external factors, internal factors or a combination of both.
- An examination of the crisis, which, doubtless, was done, was thus the first instance of the examination of management action; how far did the management cause the crisis in the first place? An important aspect of this examination is the concept of principal-agent relationship and how it was understood and practiced by all the stakeholders. How did management perform as regards the same aspect?
- Also, while analyzing the problem of agency an attempt was made to understand if there was a relation between the ownership structure of the company and performance of the company.
- A macro level analysis of retail and aviation industries was done to understand the challenges and opportunities of the respective industries.

An examination of the above would mean studying social action (in a Weberian sense) within the organizations concerned. It makes for a study of interactions between groups of people having similar and not-so-similar interests and imperatives, and, at times, also perhaps a conflict of interests, if not perception. The focus is on managements as the agency being in the 'cockpit'.

Methodology

I used case study method to carry out the present study. Two cases were studied. I have used both primary and secondary sources for data collection. The in-depth interview method was the main method used for collecting primary data, although at times I have used observation method. Interviews were carried out among key stakeholders of Air India and Subhiksha. Apart from primary data secondary data was largely used for this project. Company reports, business journals and newspapers were the main sources for secondary data.

Theoretical Orientation

The study is interdisciplinary in nature and draws heavily from New Institutional Economics and New Economic Sociology. The theoretical chapter can be broadly classified into three sections. The first section gives a brief account of Max Weber's projection of Economic Sociology. It is used as an entry point to the more focused discussion on New Institutional Economics and New Economic Sociology, which is the second section of the chapter. The second section deals with the broad ideas and debates of New Institutional Economics and New Economic Sociology. In the third section the chapter narrows down to the agency theory and theories of corporate governance as derived from New Institutional Economics and New Economic Sociology. Agency theory and theories of corporate governance are the operational theories of the present study. The thesis tries to analyze the cases from the concept of agency and governance theories.

Retail Industry

Retail industry is one of the most important sectors for Indian economy. Retail is presently the largest employer after agriculture. Indian retail sector is highly fragmented with a major chunk of its business being done by the unorganized retailers like the family run stores and the corner stores. Around 8%(according to Indian retail report, 2013) of the total retailing done in India falls under the rubric of organized retailing rest 92% of retailing is still done through unorganized retailing. Clothing and apparel is the largest section of organized retailing. Other important segments of organized retailing are "Food and Grocery" and "Mobile and telecom.

The history of organized retail is not very old. There are different kinds of challenges that organized retailers in India come across.

1. Government restrictions on FDI (Foreign Direct Investment).
2. Lack of a uniform tax and regulations.
3. Lack of adequate infrastructure, supply-chain constrain.
4. Labor employment problems.
5. High cost of real estate.
6. Low penetration of private labels.
7. Unique Indian customer.
8. Huge unorganized retail sector.

In a place like India, where unorganized retailing is the rule for a first generation unlisted organized Retail Company (like the case) the external business or industrial environment is very challenging. The economic landscape of India continues to be dominated by family firms. The case we have studied is a family run company (SME sector) which has its own internal governance challenges.

Subhiksha

Subhiksha was founded in 1997 by R. Subramanian (RS), an IIT- and IIM- alumnus. The word “Subhiksha” is derived from the Sanskrit word, “Subhiksham” which means "giver of all things good." Subhiksha opened its first store in 1997. In a span of 10 years the number of Subhiksha stores jumped from 1 to over 1000. It sold Fast moving consumer goods (FMCG), pharmaceutical products, grocery items, mobile phones, phone accessories, and fruits and vegetables (F & V). Subhiksha became the largest supermarket and mobile retail chain in India with presence in 90 cities.

Problems for Subhiksha started in October 2008, after it realized that it is out of cash and the working capital requirement was huge. Thus, it started getting legal notices from suppliers, vendors, media etc., for outstanding payments. In January 2009, the retail chain was left with no other option but to stop its entire operation. At that point of time it had around 1600 stores all over India. In 2008-09 the Indian economy was experiencing a slowdown, because of the slowdown India retail market was experiencing falling demands and most of the retailers were

having problems. It is worth noting here that apart from Subhiksha other retailers survived the slowdown.

Subhiksha's failure was the result of recession, capital structure and over expansion. The equity base of the company was very low and it expanded mainly depending on debt, by taking loans from the banks. Instead of working on its equity base and analyzing the negative consequences of low equity the company concentrated on increasing the number of stores. The recession struck the India economy by the end of 2008, when Subhiksha was in the middle of its huge expansion programme. Due to the negative effect of the slow down on the financial sector of India, external source of funds for Subhiksha stopped. The huge debt burden on Subhiksha due to its uncontrolled expansion on debt left the company with no other option but to shut down. The management of Subhiksha explained that the company was a victim of the situation. It was the economic slow down which ruined the company.

The relation between the major shareholders of Subhiksha (ICICI-Venture and Promoter Subramanian) during the crisis was telling a different story of Subhiksha's failure. After the Registrar of Companies (Chennai) received investigation request by I-Venture and found that Subhiksha was not paying PF dues and salaries, RoC started probing. Subhiksha, they found, was regularly breaking rules. In April 2010 RoC submitted its report to the Misnistry of Corporate Affairs. RoC made a litany of charges against Subhiksha: paper companies were set up to manipulate accounts and siphon money, transactions with related parties were not disclosed, and the board just did not do its job. In October, 2010 Serious Fraud Investigation Office (SFIO) of The Ministry of Corporate Affairs started looking into the case of Subhiksha. RoC in its report suggested that since it is a case of systematic, gigantic fraud SFIO should investigate.

The story of Subhiksha typifies the struggles of the Indian organized retail sector, which is caught in the whirlpool of bad decisions, confused formats, immature expansion, unjustifiable investments, excessive optimism and above all recession. It was over expanding at a time when there was financial turmoil going on, so it was quite natural that it failed to get extra credit from banks. Thus the expansion was ill-timed. Again on the other hand it failed to optimize on its

own resources. If nothing else, the Subhiksha episode exposes the Indian regulatory and banking system's deep vulnerability. Whether it is private equity firms willing to glance the other way in return for a quick buck, accounting firms relying excessively on management-speak or banks desperate for business, promoters accused of violations always manage to stay ahead.

Aviation Industry

Aviation Industry in India is growing at a very fast pace. With the liberalization of the Indian aviation sector, aviation industry in India has undergone a rapid transformation. Initially it started as an industry with two government controlled state owned sector, but gradually with passing time different full service private players as well as low cost private airlines have made their mark in the civil aviation sector. According to the Indian Aerospace Industry Analysis report (2013), in terms of passenger traffic, India is currently the ninth largest aviation market in the world. With regards to air cargo tonnage, India leads the South Asian region -consisting of Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka.

Aviation as an industry is extremely capital intensive. Even after several attempts the price of Aviation Turbine Fuel (ATF) continues to increase exponentially. Apart from ATF airport charges, unavailability of commercial pilots, higher cost of capital and inflexible labor laws are some structural challenges which all airline companies are currently experiencing. While most of these factors are not under direct control of airline operators, the problems have compounded due to industry-wide capacity additions and liberal bilateral grants by the government much in excess of actual demand. This is one industry which already has the problem of oversupply; constant capacity addition makes the situation even harder. Factors such as cost of oil or security have direct impact on operational effectiveness and risk management of an airline company. Factors such as natural disasters or health emergencies and socio-political culture of a country, which affect the financial health of the industry, lie outside the control of airline executives.

The industry is structurally unattractive, weighed down by regulations, and influenced by several uncontrollable factors. The combined effect of these factors is historically the industry has never earned a rate of return above its investors' capital; in fact, it has destroyed more money than it has created.

Air India

On July 1932 the aviation department of Tata Sons Ltd. was established. Air services in India began in October 1932 under the Aviation Department of Tata Sons Ltd, which was succeeded by Tata Airlines. This was subsequently renamed in July 1946 as Air India Ltd., and incorporated as Air India International Ltd., in March 1948. The company changed its name back to the original Air India on 8th June 1962.

On 15th June 1953 former independent companies, namely Air Service of India (A.S.I), Deccan Airways, Himalayan Aviation, Airways India, Bharat Airways and Kalinga Airlines were merged to form the new domestic national carrier Indian Airlines Corporation (I.A.C/IA/IC). All these airlines have been privately owned, except Deccan in which the government held a 70% interest, purchased from the state of Hyderabad.

Sometime between the years 2006-07, the government took a decision to amalgamate two government companies Indian Airlines and Air India Ltd. The declining market share and operating losses posed a serious threat for the future survival of the two airlines on a stand-alone basis. It was felt that as size of a company is a critical factor for the successes of an airline company merging both the airlines would give the company a fighting chance amidst fierce global and domestic competition, as it would provide an opportunity to leverage combined assets and capital better and build a stronger sustainable business. It was also felt that merging the airline would also give the company greater acceptability amongst the global alliances.

The merged company is passing through severe financial crisis. There are several reasons for this crisis which have occurred because of the decision of merger. Although the legal merger was done few years ago actual merger is yet to take place. HR integration still remains as a big

problem, apart from that several technical issues regarding merger are still pending. All in all the entire decision of merger has turned out to be a big mistake. If, we look at the figures we will see that post merger the company has made more loss than pre-merger. Whatever benefits were expected out of the merger did not materialize. The total accumulated loss of the company is increasing year after year.

The major internal and external causes for Air India's crisis are as stated below:

External: External causes are the problems which exists outside the company, threats which come from the external environment. These challenges are uncontrollable, but the strategies taken by the company should take into account of the potential threat otherwise these threats become causes for a company's failure.

- Rising ATF prices & steep rupee depreciation
- Rules and regulations
- Bilateral agreements and open sky policies
- Economic Slowdown

Internal: internal causes refer to problems initiated by the company management, problems which has aroused due to improper decisions. These factors are controllable but Air India has failed to control it.

- Huge Delays in Actualization of Merger/ Integration
- Aircraft acquisition
- Risks of Debt Funded Acquisition
- Route Rationalization and Network Integration and its impact
- Proper utilization of assets and infrastructure
- HR and IR issues
- Role of management and Government intervention

Corporate Governance

The crux of the corporate governance problem lies in the separation of ownership and control. With the rise of Joint Stock Company ownership became large and dispersed containing retail

shareholders, institutional investors, promoter shareholders etc. In the changed scenario, it is practically impossible for this gamut of shareholders to take care of the day to day management of the company. Thus a small group of professional managers run the firm, hence have control rights. This small group by virtue of running the company holds important information which the owners may or may not know. From the point of the shareholders' monitoring the managers are a costly endeavor. With lack of monitoring and privileged information the managers may not always act in the best interest of the shareholders rather they intend to run the company in their own interests. Managerial opportunism creates agency costs. Corporate governance try to mitigate agency problems.

In India, concentrated ownership and control is the rule rather than the exception. Under concentrated ownership and control, the nature of the agency problem is essentially different from that present in diffuse ownership structures. While in the latter, agency problems arise on account of shareholder manager conflicts, dubbed in the literature as Type I or vertical agency problems, in the former, agency problems arise primarily due to conflicts between the two categories of principals—the controlling inside shareholders and dispersed minority outside shareholders, dubbed as Type II or horizontal agency problems (Roe, 2004). The key difference in the nature of agency problem between promoters controlled firms and management controlled firm is that in the former the agents work only for one shareholder and in the latter the agents do not work for the shareholder (Parmer, 2004).

The cases discussed in the thesis are examples of companies having type II agency problems. Here the agents are the principals which lead to several other governance problems. The fraud angle becomes quite strong in this kind of scenario. In India broadly companies can be divided in three categories: 1. Public sector units, 2. Family run companies and 3. Multinational companies. The two cases discussed in the previous chapters are examples of PSU and family run business. In PSU Government is the majority share holder. In family run business the founding family or the promoter is the majority shareholder and in MNC the foreign parent is the majority shareholder.

Family Firms and Governance

According to Jensen and Meckling agency costs are least in a family firm, thus it is the least costly (most efficient) forms of organizational governance. In reality Family firm suffers from Type II agency problems or in Perrow's definition "owner opportunism". In a family firm the agency problem comes from the principals' side, principals who shirk, cheat, and opportunistically seize perquisites for their own use. In a family firm the agency problem comes from the non-alignment of interest between the minority (non-controlling) and the majority shareholders.

Private ownership frees firms from the discipline imposed by the market for corporate control (Jensen 1993) and increases the agency threat posed by self-control. This agency threat comes from the fact that the owner-manager can also be motivated to take actions favoring his or her personal interest over the firm's interest. Power is asymmetrically distributed in a firm. In a family firm owner- managers are more powerful, thus it is possible that an owner can engage in exploitative behavior with subordinates (Perrow,1986). In a family firm, agency cost does not come from the exploitative behavior of the management, but it comes from the shareholders' opportunistic behavior. Moreover, private ownership reduces the control of external governance and increases the self-control problems. If the owner-manager of the firm has no self-control and engage in unethical and exploitative behavior, external governance will be less effective to stop this kind of behavior. These attributes typify the case of Subhiksha.

Governance of Public Sector Units (PSUs)

The growth of Public enterprises in India has been varied and complex. They are generally set up as government companies or statutory corporations, wherein the respective functions of government, parliament, and the enterprise are specified. The objective of providing this form of organization is to make them independent of the normal governmental machinery and to provide them with the necessary autonomy to operate like any other business or commercial enterprise. By 1970s, PSUs started having various management problems and sickness were reported by firms. It was increasingly felt that more technical and specialized managerial knowledge and skill was required for managing the operations of these PSUs on an ongoing basis.

In 1972, the Bureau of Public Enterprises took the first step in creating independence for the PSUs by recommending the creation of the position of a Chairman cum Managing Director along with a part-time director who would assist him/her to oversee the functioning of the PSU Board. This would provide it autonomy from the administrative oversight of the parent ministries. The Administrative Reforms Committee of 1975 suggested further independence for the PSUs and the need to include non-government individuals on the Board so that operational efficiencies could be pursued.

With liberalization in 1991, the importance was given on efficiency of the PSUs. PSU reforms were targeted to gain better board independence so that they can become more competitive. According to Dewan (2006) while pre-liberalization reforms suggested a separation between the owner and the controller, i.e., the government and the board, respectively, the post-liberalization SEBI guidelines suggested a balance of power between the insider, i.e., the executive chairman and the outsider, i.e., the independent director. Apart from the governance problem of majority-minority shareholding PSUs face some other unique governance problems. These problems come from lack of board independence, multiplicity of objectives both economic and non-economic, several monitoring agents and most importantly its “state” character. The combined effect of this entire governance problem for an airline company as Air India is havoc.